FRS 102 Business Combinations
Factsheet 6

by Robert Kirk

One of the most complicated aspects in FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland can be found in Section 19 on how to account for a business combination. As a result, a new Factsheet 6 was published in December 2018 to help preparers implement the rules. In this article I will illustrate how the rules apply with a couple of 'live' examples from Irish published accounts, both North and South. The factsheet includes the latest amendments introduced from the 1st January 2019 and these are contained in the latest version of FRS 102 published in March 2018.

We normally think of a business combination as a situation where one entity (the acquirer) purchases another (the acquiree) but, of course, it encompasses all situations whereby there is a bringing together of separate entities or businesses into one reporting entity regardless of their structure. It therefore includes mergers and even the purchase of assets from another entity rather than the entity itself.

Although mergers were previously accounted for under the technique of merger accounting this was banned by the International Accounting Standards Board (IASB) a number of years ago and that decision was endorsed in FRS 102. It means that all business combinations, apart from group reconstructions, must adopt the purchase or acquisition model. An acquirer therefore must be identified in all circumstances in a business combination.

FRS 102 and Factsheet 6 have identified the following five steps that must be followed in any business combination:

Step 1 Identify the acquirer

An acquirer must be identified in all business combinations even if it is a fairly even share forshare exchange. Other factors such as the make-up of the new management team must be assessed to identify which of the two parties effectively control the combined new entity. In some rare cases it could be that entity A appears to have legally acquired entity B but it has transferred so many shares to B that it really passes control over to B. In assessing who is the acquirer we do not follow the legal form but instead apply the 'substance' of the arrangement. This example is known as a reverse takeover and entity B is identified as the acquirer. In the vast majority of combinations there is no conflict between the legal form and the substance of the agreement and the acquirer (entity A) is usually the party paying out cash to acquire the ordinary shares in entity B.

Step 2 Date of the business combination

This is normally the date when the agreement is signed between the two parties and control passes on that date. However, there are some circumstances when control does not pass until a future date and, if that is the case, then the purchase method can only be applied at that date.

Step 3 Measure the cost of the combination

This is defined as the fair value of any consideration given in exchange for control, plus any costs of acquisition. This could consist of any combination of cash, cash equivalents, other assets, liabilities incurred or the issue of ordinary shares.

An example of the cost or purchase consideration is provided by Carbery Food Ingredients Ltd. The cost or purchase consideration was a mixture of cash and acquisition costs which are added and thus spread over the useful life of goodwill.

Carbery Food Ingredients Ltd

Year ended 31st December 2018

Goodwill

Positive goodwill acquired on each business combination is capitalised, classified as an asset on the consolidated statement of financial position and amortised on a straight-line basis over its useful life of 20 years. The fair value of the assets and liabilities are based on valuations using assumptions deemed by management to be appropriate to do so.

Goodwill acquired in a business combination is, from the acquisition date, allocated to each cash generating unit that is expected to benefit from the synergies of the combination.

If a subsidiary, associate or business is subsequently sold or discontinued, any goodwill arising on acquisition that has not been amortised through the income statement is taken into account in determining the profit or loss on sale or discontinuance.

Other Intangibles

Intangible assets acquired separately from a business are capitalised at cost. Intangible assets acquired as part of an acquisition of a business are capitalised separately from goodwill if the fair value can be measured reliably on initial recognition.

Intangible assets acquired as part of an acquisition are not recognised where they arise from legal or other contractual rights, and where there is no history of exchange transactions. Intangible assets, excluding development costs, created within the business are not capitalszed and expenditure is charged against profits in the year in which it is incurred. Subsequent to initial recognition, intangible assets are stated at cost less accumulated amortisation and accumulated impairment.

Intangible assets are amortised on a straight-line basis over their estimated useful life as follows:

Intangible formulae
5 to 10 years

Intangible Process Technology
5 to 10 years

Customer relationships
5 to 10 years

ERP systems / software
5 to 10 years

If there are indicators that the residual value or useful life of an intangible asset has changed since the most recent annual reporting period previous estimates shall be reviewed and, if current expectations differ, the residual value, amortisation method or useful life shall be amended.

Changes in the expected useful life or the expected pattern of consumption of benefit shall be accounted for as a change in accounting estimate.

Acquisitions of subsidiary undertakings

The Group acquired 100% of the share capital of Janousek S.p.A. in April 2018

	Book Value	Fair Value Adjustment	Adjusted Value
	€	€	€
Intangible assets	14	-	14
Tangible assets	4,226	-	4,226
Other intangible assets	-	2,500	2,500
Inventory	866	(139)	727
Debtors & prepayments	1,170	-	1,170
Creditors due within 1 year	(1,360)	-	(1,360)
Bank debt & overdrafts	(3,285)	-	(3,285)
Deferred taxation arising on acquisition	-	(295)	(295)
			3,697
Goodwill arising on acquisition			1,743
			5,440
Discharged by:			
Purchase consideration			
- Cash paid			5,000
- Acquisition costs			440
			5,440

Intangible Assets				
	Goodwill	**Other intangibles**	**ERP Project**	**Total**
Group Cost	€	€	€	€
At 1 January 2018	74,669	25,773	8,980	**109,422**
Acquisitions (Note 22)	1,743	2,514	-	**4,257**
Additions	-	10	791	**801**
Exchange movements	3,007	1,222	302	**4,531**
At 31 December 2018	79,419	29,519	10,073	**119,011**
Amortisation & impairment:				
At 1 January 2018	45,187	22,656	1,024	**68,867**
Amortised during the year	3,741	2,141	896	**6,778**
Exchange movements	1,781	1,130	66	**2,977**
At 31 December 2018	50,709	25,927	1,986	**78,622**
Net book value:				
At 31 December 2018	28,710	3,592	8,087	**40,389**
At 31 December 2017	29,482	3,117	7,956	**40,555**

Goodwill and other intangibles primarily result from prior acquisitions within the Synergy division. Other intangibles include formulas, process technology and customer relationships separately identifiable at the respective acquisition dates. Goodwill and other intangibles are amortised over their expected useful lives and are also subject to annual impairment testing or more frequently if there are indicators of impairment. The amortisation of Goodwill and Other Intangibles charged to the Consolidated Income Statement in 2018 is €6.8million.

Under FRS 102, investments in ERP systems software are classified as intangible assets and currently the Group is engaged in such investments in our Ireland and Synergy divisions some of which has become available for use during 2016 in Synergy America's, during 2017 in Synergy Europe and during 2018 in Ireland with Synergy Asia scheduled to come online during 2019.

The recoverable amount of goodwill and intangibles allocated to a cash generating unit (CGU) is determined based on a value in use computation. Goodwill and intangibles acquired in a business combination are allocated to CGU's that are expected to benefit from the business acquisition. Where practically measurable and identifiable, intangible assets are sub-allocated within CGU's at specific location or site level or otherwise they are grouped at a geographical or divisional level.

The key assumptions employed in arriving at the estimates of future cash flows factored into impairment testing are subjective as they are based on a combination of management's past experience and estimates of future outcomes. Key assumptions include managements' estimates of future profitability, cash flow components and discount rates.

Cash flow forecasts employed for the value in use calculations are for a five-year period approved by management and a terminal value which is applied to year five cash flows. The terminal value reflects the discounted present value of the cash flows beyond year five which is based on projected long-term growth rates for the particular market in which the CGU operates. The present value of future cash flows is calculated using pre-tax discount rate which is based on the Group's weighted average cost of capital (WACC) adjusted to reflect the risks associated with that specific CGU.

Step 4 Allocate the purchase consideration to net assets acquired

This process involves trying to measure the net assets acquired at their fair value at the date of control passing. Generally, this does not pose major problems when valuing tangible assets as there are often market prices to adopt as fair value. However, that is not the case for intangible assets. Until the amendment to FRS 102 in March 2018 (effective from the 1st January 2019) acquirers had to try and identify as many intangible assets as they could find and effectively call goodwill by another name. It was essentially an attempt to get acquirers to justify why they might have purchased the acquiree. This resulted in a number of unusual identifiable intangibles being recorded for the first time e.g. brand names, customer lists, non-contractual customer relationships etc.

The feedback from many commentators on how FRS 102 was working was that the Financial Reporting Council (FRC) had gone too far. It was difficult in the first place to identify these assets and also very time consuming and expensive to measure them at fair value. Often expert valuers had to be employed. As a result, from January 1st 2019 an intangible asset will only have to be recorded in an acquisition if it meets all of the following three criteria:

a. the recognition criteria are met (ie that it is probable that economic benefits will flow, and the value of the asset can be measured reliably);

b. the intangible asset arises from contractual or other legal rights; and

c. the intangible asset is separable.

Factsheet 6 states that normally licences, copyrights, trademarks, internet domain names, patented technology and legally protected trade secrets would be expected to meet all three criteria. However, it does not expect customer lists, customer relationships and unprotected trade secrets to meet all three criteria as no contractual or legal right exists that would give rise to expected future economic benefits.

However, in addition, the latest amendments offer acquirers the option to recognise, separately from goodwill, intangible assets that meet the recognition criteria ((a) above) and only one of the other two conditions (ie either (b) or (c)). If that policy option is taken, it must be applied consistently to all intangible assets in that class across all business combinations.

In the Carbery Food Ingredients Ltd example it is not clear exactly what the €2,500,000 other intangibles acquired represent but they could possibly still include customer relationships as well as process technology and formulae.

An example of one company in Northern Ireland that has clearly identified customer relationships and brand names on its consolidated balance sheet is Westland Horticulture Ltd. Under the amendments, however, there is a transitional exception where the above requirements should only be applied prospectively (i.e. only for those business combinations occurring in the first reporting period in which the amendments are applied or subsequently).

Therefore, any intangible assets recognised separately from goodwill in earlier business combinations will not be subsumed into goodwill.

Westland Horticulture Ltd
Year ended 31st August 2018

Intangible assets and amortisation

Intangible assets are stated at cost less accumulated amortisation and accumulated impairment losses. Amortisation is calculated using the straight-line method to allocate the depreciable amount of the assets to their residual values over their estimated useful lives as follows:

i. Goodwill – 10% straight line

ii. Patents – 10% straight line

iii. Brands – 10% straight line

iv. Customer relationships – 10% straight line

Amortisation is charged to administrative expenses in the profit and loss account.

Negative goodwill arising on acquisitions up to the fair values of the non-monetary assets acquired is recognised in the profit and loss account in the periods in which the non-monetary assets are recovered, whether through depreciation or sale. Negative goodwill in excess of the fair values of the non-monetary assets acquired is recognised in the profit and loss account in the periods expected to be benefited.

Intangible Assets						
	Goodwill	**Patents**	**Brands**	**Customer relationships**	**Negative goodwill**	**Total**
Cost	**£**	**£**	**£**	**£**	**£**	**£**
At 1 September 2017	5,626,470	45,460	395,284	25,636	(420,925)	**5,671,925**
Currency translation differences	-	(811)	-	-	-	**(811)**
At 31 August 2018	5,626,470	44,649	395,284	25,636	(420,925)	**5,671,114**
Accumulated amortisation						
At 1 September 2017	2,813,223	34,849	79,056	5,128	(84,184)	**2,848,072**
Charge for the year	562,644	8,851	39,528	2,564	(42,092)	**571,495**
Currency translation differences	-	(544)	-	-	-	**(544)**
At 31 August 2018	3,375,867	43,156	118,584	7,692	(126,276)	**3,419,023**
Net book amount						
At 31 August 2018	2,250,603	1,493	276,700	17,944	(294,649)	**2,252,091**
At 31 August 2017	2,813,247	10,611	316,228	20,508	(336,741)	**2,823,853**

Another issue that can come up in step 4 is when an acquirer does not acquire 100% of the shares in the acquiree entity. That results in the creation of what is now termed non-controlling interests (formerly minority interests). Although full international standards permit two methods of measuring their value FRS 102 has clarified in the latest amendments that only the 'parent entity' method may be adopted. Essentially it means that their valuation will not include their share of goodwill in the acquiree entity – they will only include their share of all of the fair value of identified intangible and tangible net assets in the acquiree.

Step 5 Recognition of goodwill

The final step is to compare the purchase consideration to the fair value of the net assets acquired. Invariably this will be a positive figure and results in the creation of goodwill on the consolidated statement of financial position. An example can be seen in the Carbery Food Ingredients Ltd financial statements where goodwill of €1,743,000 was created on the acquisition of Janousek SPA.

Unlike the full international standards FRS 102 then requires acquirers to amortise the goodwill over its estimated useful life but if that cannot be reliably measured then it must be amortised over a maximum period of 10 years.

Occasionally an acquisition can result in the purchase consideration being less than the fair value of the net assets acquired. This is referred to as negative goodwill or badwill. It could be caused if an acquirer is able to buy another entity at a bargain price or it could be in anticipation of incurring future losses which have to be compensated for.

The accounting treatment is the same for both scenarios. FRS 102 again differs from full international standards in that it does not permit the balancing credit figure to go direct to profit. Instead it requires the credit balance to be initially recorded as a negative asset directly underneath positive goodwill.

It then has to be released into profit as the tangible assets acquired in the acquisition are recovered. However, this leads to problems as inventories are normally sold off within a couple of months whereas acquired property could last 50 years. Often companies will average out a release period. An example of that can be seen in the financial statements of Westland Horticulture Ltd where it would appear that the company is releasing 10% per annum back into profit.

Factsheet 6 also covers the amortisation of goodwill. There is no requirement for compulsory annual impairment calculations as goodwill is already being amortised.

It is therefore only subject to an impairment review when there is an indicator of impairment. Clearly the recoverable amount of goodwill cannot be measured directly, because it cannot be sold by itself and does not generate independent cash flows.

Therefore, its recoverable amount must be derived from measurement of the recoverable amount of the cash-generating units (CGU) of which it is part. If an impairment loss is to be recognised against a CGU, that loss is first allocated to reduce the carrying amount of goodwill allocated to that CGU, before being allocated to the other assets of the CGU on a pro rata basis. This is essentially the same process as for companies applying full international reporting standards.

In addition, factsheet 6 also recognises the complexity of business combinations and the importance for acquiring entities to provide clear disclosures to ensure users can understand them. FRS 102 includes a number of disclosure requirements across three sections of the standard which cover general information on subsidiaries (and special purpose entities) that are both included and excluded from consolidation and detailed information about amounts included in the consolidation.

Additionally, the Regulations also require the following disclosures:

- Certain information about subsidiaries including their name, location, shareholding and type of share as well as whether they are included or not in the consolidation.
- In the year of acquisition (where the acquisition significantly affects the figures shown in the group accounts), whether acquisition accounting has been applied and a tabular disclosure of the carrying and fair values of each class of assets (including goodwill and negative goodwill) and liabilities with an explanation for any significant adjustments.

Examples of some are included in the examples above. However, readers should also refer to the actual Factsheet itself where a detailed disclosure example is provided.

Conclusion

Accounting for business combinations is only likely to be an issue for the larger private company which might get involved in such activity. However, for those acquirors there is a lot of work required at the date when control passes, and it will probably require the services of specialist accountants and valuers as advisers. That can turn out to be an expensive exercise as well as having to carefully identify the five steps above and ensure that the accounting and disclosure treatment complies with FRS 102.

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