FRS 102 FACTSHEET 6
BUSINESS COMBINATIONS

Business combinations

A business combination is defined as the bringing together of separate entities or businesses into one reporting entity and may be structured in a number of ways for legal, taxation or other reasons. It may involve the purchase by an entity of the equity of another entity, the purchase of all the net assets of another entity, the assumption of the net liabilities of another entity, or the purchase of some of the net assets of another entity that together form one or more businesses.

Section 19 *Business Combinations and Goodwill* sets out the requirements for business combinations. This section also includes the requirements for group reconstructions, however, this is not covered in this factsheet.

This factsheet has been prepared to provide a high level overview to entities applying FRS 102 that undertake a business combination for the first time covering the following:

- An outline of the purchase method
- The separation of intangible assets from goodwill
- Illustrative disclosures

This factsheet has been prepared by FRC staff and provides high level guidance to entities applying FRS 102 that undertake a business combination for the first time. . It should not be relied upon as a definitive statement on the application of the standard nor is it a substitute for reading the detailed requirements of FRS 102.

The Purchase Method

Key FRS 102 references

The purchase method is the required accounting treatment for the vast majority of business combinations[1] and involves the following steps: *19.6, 19.7*

1) Identify an acquirer

This is the entity which obtains control of other combining entities or businesses. *19.8 to 19.10*

2) Determine the acquisition date

This is the date that control is obtained, and the date from which the purchase method is applied. *19.10A*

3) Measure the cost of the business combination

This is the total fair value of any consideration given in exchange for control, plus any costs of acquisition. The consideration may include any combination of cash, cash equivalents, other assets, liabilities incurred or the issue of equity instruments. *19.11 to 19.13B*

4) Allocate at the acquisition date, the cost of the business combination to the assets acquired and liabilities assumed, and recognise and measure any non-controlling (minority) interest

An acquirer must identify and determine the fair value of the assets, liabilities and contingent liabilities of the acquiree at the acquisition date. Any difference between this and the cost of the business combination (determined in step 3) is dealt with in step 5 below. *19.14 to 19.21*

The non-controlling (minority) interest is recognised at the date of acquisition and is measured at its share of the net amount of the identifiable assets, liabilities and provisions for contingent liabilities of the acquiree identified and measured as described above. This interest will change over time as the acquiree's net assets (as stated in the consolidated financial statements) change.

5) Recognition and measurement of goodwill

Goodwill arises when the cost of the combination exceeds the fair value of the identified net assets acquired; for example, if CU100m is paid for CU75m of net assets, then goodwill of CU25m arises. Negative goodwill arises if the cost is less than the fair value of the net assets acquired. Both goodwill and negative goodwill[2] are recognised on the statement of financial position as assets. *19.22 to 19.24, Section 27*

Goodwill is amortised over its finite useful life and impaired if necessary. In the vast majority of cases, we expect entities to be able to estimate a reliable useful life for goodwill. Provided the entity is able to support its choice of useful life, there is no upper limit in this situation. However, in exceptional circumstances, if an entity is unable to do this, the standard does impose an upper limit of 10 years. It is not a 'default' position and a shorter useful life may be used.

Because goodwill is amortised, it is only subject to an impairment review when there is an indicator of impairment. The recoverable amount of goodwill cannot be measured directly, because it cannot be sold by itself and does not generate cash flows independently. 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.

[1] In certain circumstances merger accounting may be used such as for group reconstructions and public benefit entity combinations that are a merger. Certain conditions need to be met before this is permitted (see paragraph 19.27 to 19.33 and Section 34 of FRS 102). This factsheet does not cover merger accounting.

[2] Paragraph 19.24 sets out the subsequent measurement requirements for negative goodwill.

Intangible assets acquired in a business combination

Key FRS 102 references

Step 3 of the purchase method requires an entity to identify and determine the fair value of an acquiree's assets, liabilities and contingent liabilities. An acquiree may have both intangible and tangible assets. The Triennial Review 2017 Amendments introduced a change in the requirements to separate intangible assets acquired in a business combination.

Mandatory separation

Intangible assets acquired in a business combination **must** be recognised separately from goodwill when all three of the following conditions are met: *18.8*

(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.

We would normally expect licences, copyrights, trademarks, internet domain names, patented technology and legally protected trade secrets to meet all three criteria. We would not normally 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. *Basis for Conclusions B18.10*

Optional additional separation

FRS 102 allows entities the option to additionally 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)). When this policy option is taken, it must be applied consistently to all intangible assets in that class across all business combinations.

Transitional exception

The Triennial Review 2017 Amendments include 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 are not now subsumed into goodwill. *1.19(b)*

Illustrative disclosures

Key FRS 102 references Sections 9, 18 and 19

Business combinations can be complex and it is important that entities 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: *SI 2008/410*

- 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. *Sch 4 para 1, 16 and 17*
- In the year of acquisition (where the acquisition significantly affects the figures shown in the group accounts), whether acquisition or merger 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. *Sch 6 para 13(2) and (4)*

The illustrative disclosures that follow, focus on the requirements in Sections 18 *Intangible Assets other than Goodwill* and Section 19 *Business Combinations and Goodwill*, and the Regulations noted above.

Illustrative example

Entity Z has a year end of 31 December and acquires 100% of the ordinary shares in Entity A Ltd on 1 April 2017 for £5.5m in cash and ordinary shares. This is the first acquisition it has undertaken; the primary reason for this strategic move is to expand its geographical presence.

The fair value of Entity A's net assets at the date of acquisition is £2.0m. As part of the acquisition, Entity Z acquires Entity A Ltd's brand which has been valued at £2.95m and believes that the brand will generate benefits for the combined business for the next 12 years and have no immediate plans to change the name of Entity A. Management estimate the useful life for the goodwill to be 8 years.

Entity Z Group

Consolidated Financial Statements

Notes to the financial statements

Accounting policies

Basis of consolidation

The Group financial statements consolidate the financial statements of the Company and its subsidiary undertakings drawn up to 31 December each year. The results of subsidiaries acquired or sold are consolidated for the periods from or to the date on which control passed.

Business combinations are accounted for under the purchase method. Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Illustrative disclosures

Key FRS 102 references

Notes to the financial statements

Business combinations

19.25 (a), (b), (c) and (d)

On 1 April 2017, Entity Z acquired 100% of the ordinary share capital of Entity A Ltd for total consideration of £5.5m, with £4.0m paid in cash and £1.5m of equity instruments[3].

19.25(fA) and (g)

Entity A Ltd has been providing similar services to those provided by Entity Z in its established market in the north-west of England (which includes Manchester, Liverpool and Preston) for over 20 years; these markets compliment Entity Z's existing presence in the north-east. The goodwill of £550,000 arising from the acquisition is attributable to the expertise and experience of the workforce, customer relationships and the economies of scale that will arise from combining the operations of the two businesses. Management has estimated the useful life of this goodwill to be 8 years.[4]

19.25(e) and SI 2008/410 Sch 6 para 13(4)

The following amounts of assets, liabilities and contingent liabilities were recognised at the acquisition date:

	Note	Carrying value	Adjustment	Fair value
		CU000	CU000	CU000
Property, plant and equipment	(i)	756	61	817
Brand name	(ii)	-	2,950	2,950
Software	(iii)	280	20	300
Cash and cash equivalents		323	-	323
Inventories	(iv)	399	35	434
Trade and other receivables		1,928	-	1,928
Trade and other payables		(362)	-	(362)
Bank loans		(555)	-	(555)
Provisions		(75)		(75)
Contingent liability	(v)	-	(65)	(65)
Deferred tax asset / (liability)	(vi)	(171)	(574)	(745)
Total identifiable net assets		2,523	2,427	4,950
Goodwill				550
Total				5,500

SI 2008/410 Sch 6 para 13(4)

Adjustments on acquisition made in respect of the following:

(i) Uplift to value of properties based on an independent valuation.

(ii) Recognition of Entity A Ltd's brand on acquisition.

(iii) Recognition of software licences.

(iv) Recognition of an uplift to fair value on inventory.

(v) Recognition of a customer liability claim.

(vi) Recognition of additional deferred tax liability due to the acquisition.

19.25A

Entity A contributed £3.65m of revenue and £206,000 of profit to the group for the 9 month period from 1 April 2017.[5]

[3] Paragraph 19.25(d) requires disclosure of the total cost of the combination and a description of the components of that cost. It does not prescribe a particular format of presentation and therefore any appropriate format can be used; for example this illustration provides that information in narrative form, however, a tabular form may be more appropriate if the consideration is made up of more components, which may include, for example deferred or contingent consideration.

[4] Paragraph 19.25(g) only requires disclosure of the supporting reasons for the period chosen in the rare case that the useful life of goodwill cannot be estimated reliably.

[5] It is assumed that this business combination is material because it is the first acquisition that has been undertaken, therefore this disclosure is required by paragraph 19.25A.

Key FRS 102 references

Notes to the financial statements

Intangible assets

18.27(c),(e) and 19.26

	Goodwill	Brand names	Software	Total
	CU000	CU000	CU000	CU000
Cost				
At 31 December 2016	-	-	1,385	1,385
Acquisitions through business combinations	550	2,950	300	3,800
At 31 December 2017	550	2,950	1,685	5,185
Accumulated amortisation and impairment				
At 31 December 2016	-	-	221	221
Amortisation charge for the year	52[6]	184[7]	537[8]	773
At 31 December 2017	52	184	758	994
Carrying amount				
At 31 December 2016	-	-	1,164	1,164
At 31 December 2017	498	2,766	927	4,191

Amortisation periods

18.27(a), (b) and 19.25(g)

The goodwill and brand name were acquired as part of the acquisition of Entity A Ltd on 1 April 2017 (see note on Business Combinations for more information). Both are amortised on a straight-line basis; goodwill over a useful life of 8 years and the brand over 12 years. Entity A Ltd is an established brand in the north-west of England and there are no plans to rebrand this business in the foreseeable future.[9]

Software licences are amortised on a straight-line basis over a useful life of 3 years.

Material intangible assets

18.28(d)

The brand name of Entity A Ltd and software licences are material to the Group. The acquisition of Entity A Ltd is a part of the Group's ongoing strategic growth plan to increase its geographical presence and the associated brand name is fundamental to the success of this acquisition. The remaining amortisation period is 11 years. The software licences allow the workforce to access industry specific, proprietary software necessary to service the Group's clients. On average these licences have a remaining amortisation period of 2 years.

6 9 months of amortisation is charged in the current reporting period ie CU550,000 / 8 years x 9/12 months.

7 9 months of amortisation is charged in the current reporting period ie CU2,950,000 / 12 years x 9/12 months.

8 9 months of amortisation is charged on CU 300,000 in the current reporting period ie CU1.385m / 3 years plus CU300,000 / 3 years x 9/12 months.

9 Paragraph 19.25(g) only requires the disclosure of a supporting reason for the useful life of goodwill that is chosen in the extremely rare occasions when management are unable to reliably estimate it.