

Business combinations and goodwill

This chapter is divided into two parts covering the closely related topics of business combinations and goodwill. In the first part of the chapter, we start by discussing the economic and business context of business combinations and the ways in which such combinations may be effected. We then describe and evaluate the two methods of accounting for business combinations, the *acquisition* method and the *merger* method. The former is based on the premise that there is a purchase by a dominant partner whereas the latter assumes a coming together of more or less equal partners. We explain the provisions of the UK standard and outline those of the international accounting standard while drawing attention to proposed changes in this area. In this part of the chapter, we therefore refer to:

- FRS 6 *Acquisitions and Mergers* (1994)
- IAS 22 *Business Combinations* (revised 1998)

Although FRS 7 *Fair Values in Acquisition Accounting* (1994) is also relevant to this topic, we defer consideration of that standard until the following chapter.

In the second part of the chapter, we turn to the thorny issue of accounting for goodwill. We explain why goodwill arises and then describe the attempts of the standard setters to arrive at an appropriate accounting treatment for this, often very valuable, phenomenon. Standard accounting practice for goodwill now involves impairment reviews so we also revisit this topic which was introduced earlier, in Chapter 5. We examine the relevant UK and international accounting standards, which are:

- FRS10 *Goodwill and Intangible Assets* (1997)
- FRS 11 *Impairment of Fixed Assets and Goodwill* (1998)
- IAS 22 *Business Combinations* (revised 1998)
- IAS 36 *Impairment of Assets* (1998)
- IAS 38 *Intangible Assets* (1998)

Business combinations

Introduction

Words such as merger, amalgamation, absorption, takeover and acquisition are all used to describe the coming together of two or more businesses. Such words do not have precise legal meanings and, as they are often used interchangeably, the American description ‘business combinations’ best describes the subject matter of this chapter.

A company may expand either by ‘internal’ or ‘external’ growth. In the former case it expands by undertaking investment projects, such as the purchase of new premises and plant, while in the latter case it expands by purchasing a collection of assets in the form of an

established business. In this second case we have a business combination in which one company is very much the dominant party, acquiring control of that other business either with or without the consent of the directors of that business.

Where such 'external' growth is contemplated, it will be necessary to value the collection of assets it is proposed to purchase. It will usually be necessary to determine at least two values: (a) the value of the business to its present owners (this will determine the minimum price which will be acceptable); (b) the value of the business when combined with the existing assets of the acquiring company (this will determine the maximum price which may be offered).

In other circumstances two or more companies may both see benefits from coming together. Thus, two companies may consider that their combined businesses are worth more than the sum of the values of the individual businesses. For such a combination, the individual businesses must be valued to help in the determination of the proportionate shares in the combined business, although, of course, the ultimate shares will, to a considerable extent, depend upon the bargaining ability of the two parties.

Table 13.1 gives some indication of the importance of business combinations in the years 1991–2000. It shows acquisitions and mergers of industrial and commercial companies in the UK by UK companies.¹

Table 13.1 Acquisitions and mergers in the UK by UK companies: 1991–2000

Year	Number of companies acquired	Consideration (£million)			
		Total	Cash	Ordinary shares	Fixed interest securities
1991	506	10 434	7 278	3 034	121
1992	432	5 941	3 772	2 122	47
1993	526	7 063	5 690	1 162	211
1994	674	8 269	5 302	2 823	144
1995	505	32 600	25 524	6 617	459
1996	584	30 742	19 551	10 926	265
1997	506	26 829	10 923	15 583	323
1998	635	29 525	15 769	13 160	595
1999	493	26 163	16 220	9 592	351
2000	587	106 916	40 074	65 570	1 272

Some reasons for combining

Purchase of undervalued assets

It is well recognised that the same collection of assets may have different values to different people. As a result, it is often possible for one business to purchase another business, that is a collection of assets, at a price below the sum of the values of the underlying assets. If we take limited companies, for example, the shares of a company may be standing at a relatively low

¹ This information has been taken from Table 6.1B of *Financial Statistics*, published monthly by the Office for National Statistics.

price because the current management is making poor use of the assets or has not communicated good future prospects to the shareholders. Even though the acquiring company purchases the shares at a price higher than the existing market price, it may be able to acquire underlying assets which have a much higher value than the price paid. Indeed, as many asset strippers have shown, even the sale of assets on a piecemeal basis may generate a sum considerably in excess of the price paid for those assets.

Economies of scale

The combination of two businesses may result in economies of scale, that is to say the cost of producing the combined output will be less than the sum of the costs of producing the separate outputs or, alternatively, the combined output will be greater for the same total cost. Such economies of scale may exist not only in production but also in administration, research and development and financing.

Concentrating first on production, economies of scale may arise for such reasons as the following: set-up costs and marketing costs may be spread over larger outputs; indivisible units of high-cost machinery may become feasible at higher levels of output; where capacity is dependent on volume and cost is dependent on surface area, as in the case of storage tanks, such area–volume relationships may result in less than proportionate rises in costs.

When we turn to administration, a large organisation may attract and make better use of scarce managerial talent and enable the firm to employ specialists. Large organisations may also be able to attract suitable people to administer research and development programmes and to use the results of those programmes more effectively. In addition, the larger organisation is often in a position to raise and service capital more cheaply than a smaller organisation.

Economics textbooks devote considerable space to discussions of the theoretical bases for economies of scale, and governments have often encouraged and supported combinations on the grounds that they would improve the efficiency of British industry, in particular its competitiveness in international markets. For reasons discussed below, there is now less confidence that benefits will be obtained from combinations.

Various techniques have been developed to examine whether and to what extent economies of scale exist in practice. Although there appears to be scope for economies of scale in many industries, these do not appear automatically after a business combination, but have to be planned. A number of studies have found that the performances of many combined businesses have been rather disappointing. In particular there are diseconomies of large organisations, due mainly to the problems of administering large units, which may often outweigh the benefits afforded by economies of scale.

Elimination or reduction of competition

By eliminating or reducing competition, it may be possible for a company to make larger profits; combining with another business may be one means of achieving this end. Although integration may occur for many reasons, one reason may be that it is possible to reduce competition both by vertical integration, that is by combining with a firm at an earlier or later stage of the production cycle, or by horizontal integration, that is by combining with a firm at the same stage in the production cycle.

To illustrate, a firm at one stage of production may combine with a firm at an earlier stage of production, that is a supplier, thus ensuring a ready source of supply and perhaps putting it in a position to charge a lower price than competitors at the second stage, and hence squeeze them out of business. The extent to which this is possible would depend upon the

structure of the market, that is the extent to which there are monopolistic or competitive elements present.

Combination with a firm at the same stage of production would reduce the number of competitors by one and again may give rise to higher profits as a result of the increased industrial concentration, although much would depend upon the structure of the industry before and after the combination. The combination of two small firms in a very competitive industry might have little effect, whereas the combination of two giants might turn an oligopoly into a virtual monopoly.

There are obvious dangers to the public at large from mergers which reduce the level of competition and it is for this reason that we have legislation on monopolies and mergers.

Reduction of risk

By combining with a firm which makes different products, a business is often able to reduce risk. Thus one reason for a combination involving businesses in different industries may be a desire to generate an earnings stream which is less variable than the separate earnings streams of the two individual businesses. Such a reduction of risk is usually considered to be an advantage and will often lead to an increase in share values, although it may be argued that shareholders may be better able to reduce risk by the selection of their own portfolio of shares.

Use of price/earnings ratios

In many business combinations, one company has been able to increase the wealth of its own shareholders by combining with a company which has a lower price/earnings ratio. To illustrate let us take a simple example of two companies:

	<i>Company A</i>	<i>Company B</i>
Earnings	£10 000	£10 000
Number of ordinary shares	100 000	100 000
Earnings per share	10p	10p
Current market price	£1.50p	£1.20p
P/E ratio	15	12

Let us suppose that company A issues 80 000 shares valued at £120 000 (80 000 at £1.50) in exchange for 100 000 shares in company B valued at £120 000 (100 000 at £1.20). If there is no change in earnings after the combination, the earnings of the combined companies as reflected in the group accounts will be £20 000 and the earnings per share 11p, that is £20 000 divided by 180 000 shares in A. If the market continues to use the P/E ratio of company A, that is 15, the price of a share in company A after the combination will be £1.65. This is greater than £1.50, the price of a share in company A before the combination and hence advantageous to the original shareholders in the company. It is also advantageous to the original shareholders in company B who now hold 80 000 shares in company A valued at £132 000 compared with their former holdings of 100 000 shares in company B which were valued at £120 000.

It may be argued that the market is unlikely to apply the same P/E ratio to the combined earnings as it previously did to the earnings in company A as a separate company. An 'average' P/E ratio of 13.5, calculated as shown below, would perhaps be expected:

	<i>Earnings</i>	<i>Values</i>
Company A	£10 000	£150 000
Company B	£10 000	£120 000
Combined	£20 000	£270 000

The average P/E ratio is $270\,000/20\,000 = 13.5$.

This does not appear to happen in practice, and the resulting P/E ratio is usually well above this 'average' P/E ratio because the market anticipates a better future.

Thus, even though benefits such as economies of scale and reduction of competition do not materialise, some companies have been able to increase the wealth of their shareholders by acquiring other companies with lower P/E ratios.

Managerial motives

Under traditional economic theory, the role of management is to respond in a rational, but more or less automatic, way to circumstances which present themselves. Thus if, for example, economies of scale are perceived to be likely if two businesses combine, such a combination will be pursued in order to maximise the wealth of shareholders.

A number of studies have suggested that the usual financial and economic reasons put forward for mergers were, in practice, not of prime importance. What seemed to be a more important determinant of mergers among large companies was the objectives of managers. In order to cope with increasing uncertainty, managers desired to increase their market power or to defend their market position. Although such activities could well further the interests of shareholders, they may have even greater benefits for the managers themselves. Thus, a less uncertain life, in particular less chance of the company itself being taken over, a larger empire and perhaps larger remuneration due to control of such an empire may be extremely important motivating forces.

Whatever the ultimate objective, managerial motives seemed to play a much larger role in merger activity than traditional economic theory allowed.

Methods of combining

In order to be able to account for combinations, we must first explore some of the methods which may be used to effect them. Such methods may best be classified as to whether or not a group structure results from the combination.

Let us take as an example two companies, L and M, and assume that the respective boards of directors and owners have agreed to combine their businesses.

Combinations which result in a group structure

Two such combinations may be considered.

In the first case, company L may purchase the shares of company M and thereby acquire a subsidiary company; alternatively company M may purchase the shares of company L.

The choice of consideration given in exchange for the shares acquired will determine whether or not the shareholders in what becomes the subsidiary company have any interest in the combined businesses. Thus, if company L issues shares in exchange for the shares of

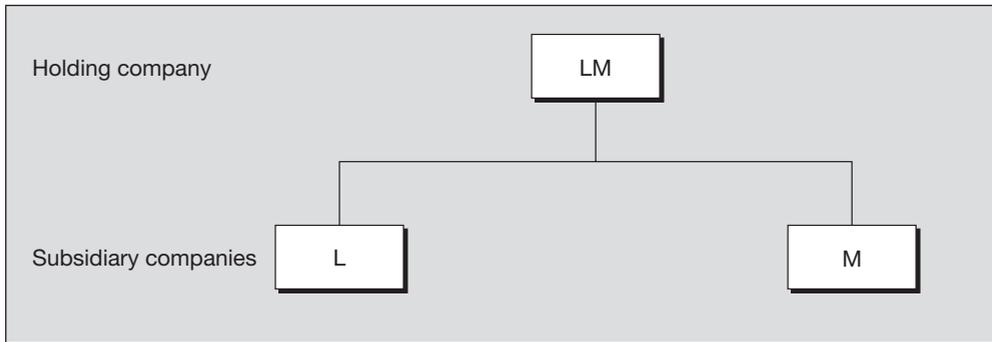


Figure 13.1 Resulting group structure after combination

company M, the old shareholders in company M have an interest in the resulting holding company and thereby in the group, whereas, if company L pays cash for the shares in company M, the old shareholders in M take their cash and cease to have any interest in the resulting group.

In the second case, a new company, LM, may be established to purchase the shares of both L and M. Thus, the shareholders in L and M may sell their shares to LM in exchange for shares in LM. The resulting group structure would then be as shown in Figure 13.1. The shareholders in LM would be the former shareholders in the two separate companies and their respective interests would depend, as in all the examples in this section, upon the valuations placed upon the two separate companies, which would in turn depend in part upon bargaining between the two boards of directors.

It is possible for company LM to issue not only shares but also loan stock in order to purchase the shares in L and M. It would be difficult for payment to be made in cash as LM is a newly formed company, although it could, of course, issue other shares or raise loans to obtain cash.

Combinations not resulting in a group structure

Again, two such combinations may be considered.

First, instead of purchasing the shares of company M, company L may obtain control of the net assets of M by making a direct purchase of those net assets. The net assets would thus be absorbed into company L and company M would itself receive the consideration. This would in due course be distributed to the shareholders of M by its liquidator.

As before, the choice of consideration determines whether or not the former shareholders in M have any interest in the enlarged company L.

Second, instead of one of the companies purchasing the net assets of the other, a new company may be formed to purchase the net assets of both existing companies. Thus, a new company, LM, may be formed to purchase the net assets of company L and company M. If payment is made by issuing shares in LM, these will be distributed by the respective liquidators so that the end result is one company, LM, which owns the net assets previously held by the separate companies and has as its shareholders the former shareholders in the two separate companies.

Preference for group structure

The above are methods of effecting a combination between two, or indeed more, companies although, in practice, virtually all large business combinations make use of a group structure,

rather than a purchase of assets or net assets. Such a structure is advantageous in that separate companies enjoying limited liability are already in existence. It follows that names, and associated goodwill, of the original companies are not lost and there is no necessity to renegotiate contractual arrangements. All sorts of other factors will be important in practice; some examples are the desire to retain staff, the impact of taxation and whether or not there is a remaining minority interest. A group structure also permits easy disinvestment by sale of one or more subsidiaries.

Choice of consideration

As discussed above, the choice of consideration will determine who is interested in the single business created by the combination and will therefore be affected by the intentions of the parties to the combination. The choice of consideration will also be affected by the size of the companies and by conditions in the market for securities and the taxation system in force.

The main possible types of consideration are cash, loan stock, ordinary shares, some form of convertible security or any combination of these.

Let us look at the effect of each of these before turning to some factors which influence the choice between them.

Cash

Where one company purchases the shares or assets of another for cash the shareholders of the latter company cease to have any interest in the combined businesses.

From the point of view of the selling shareholders, they take a certain cash sum and will be liable to capital gains tax on the disposal of their shares.

From the point of view of the purchasing company, its cash holdings will decrease. It has sometimes been suggested that the use of cash will give a better chance of success if opposition is anticipated and, provided the earnings of the company which is purchased are greater than the earnings which would be made by using cash in other ways, there will be an increase in the earnings per share.

Loan stock

In this case the selling shareholders, either directly or indirectly, exchange shares in one company for loan stock in another company. Hence an equity investment is exchanged for a fixed-interest investment, which may or may not be an advantage, depending upon the relative values of the securities and the circumstances of the individual investor. Any liability to capital gains tax will be deferred until ultimate disposal of the loan stock.

From the point of view of the shareholders of the purchasing company, there may be an advantage in that the level of gearing will be increased. In addition, interest on the loan stock will be deductible for corporation tax purposes.

Ordinary shares

A share-for-share exchange is often the method used in combinations involving large companies. Here the shareholder simply exchanges shares in one company for shares in another company.

There are many potential benefits for the selling shareholders, although the extent to which they exist will depend upon the exact terms of the combination and the relative values of the shares. The selling shareholder continues to have an interest in the combined businesses, with the benefits mentioned in the second section of this chapter, and will not be subject to capital gains tax on the exchange. Against this the value of the security received is not certain but will depend upon market reaction to the combination.

From the point of view of the combined companies, a share exchange does not affect their liquidity. The extent to which it is beneficial for the existing shareholders of the company must depend upon the relative values of the shares.

Although shares were popular in the mid-1980s, cash has been the major part of the consideration in all but two of the ten years 1991 to 2000.²

Convertible loan stock

The issue of convertible loan stock has become more common and has sometimes been used in connection with business combinations. In such a case, the shareholders in one company exchange their shares for convertible loan stock in another company.

From the point of view of a selling shareholder, an equity investment is exchanged for a fixed-interest security, but one which is convertible into an equity investment at some time in the future. Thus, if in the future share prices move in the shareholder's favour, the shareholder will be able to take up the equity interest while, if they move against the shareholder, he or she will be able to retain the fixed interest investment. Again, any liability to capital gains tax is deferred until ultimate disposal of the convertible stock or equity shares issued in exchange.

From the point of view of the company issuing such securities, the interest on the loan stock is deductible for taxation purposes and the debt is self-liquidating if loan holders convert loan stock into ordinary shares. If loan holders do convert, the tax deductibility is, of course, lost and in addition there is a reduction in gearing and possible dilution of the existing shareholders' interest.

The choice in practice

As has been seen above, the various forms of consideration which may be used have advantages and disadvantages. The choice in any business combination will depend upon a large number of factors, some of which have been discussed in this section.

It is convenient to distinguish between an agreed combination where the two sets of shareholders in the individual companies are to be shareholders in the new or enlarged company and a situation where one party is dominant and is seeking to obtain control of the other company as cheaply as possible.

In the first of these cases the major part of the consideration must obviously be equity shares although, if a situation of surplus cash or low gearing is expected after the combination, an opportunity may be taken to pay part of the consideration in cash or some form of loan stock.

In the second case the choice of consideration will be affected considerably by the nature of the companies involved and the market situation. Where the biddee company is small or opposition is expected, a cash bid may be preferred. Loan stock may be attractive where rates of interest are low and especially if they are expected to rise. Where, however, it is felt that the shares of the dominant company are overpriced relative to those of the other company, then a share issue is likely to be most attractive.

² See the statistics on p. 360 for an analysis of the total expenditure for each of the years 1991–2000 between cash, ordinary shares and fixed-interest securities.

Accounting for business combinations

Accounting for business combinations is a topic which has been the cause of considerable controversy in many countries. The traditional method of accounting for combinations in the UK was the 'acquisition' or 'purchase' method but, in the 1960s, a new method began to find favour. This was the 'merger' or 'pooling of interests' method which had been extensively used in the USA. ED 3 *Accounting for Acquisitions and Mergers*, which was published in 1971, attempted to define situations in which each method should be used but was never converted into an SSAP. Changes introduced by the Companies Act 1981 made it possible to make progress and SSAP 23 *Accounting for Acquisitions and Mergers* was issued in April 1985. This standard was the subject of considerable criticism and, in 1990, the ASC issued a revised version ED 48. The ASB then issued its own exposure draft, FRED 6 *Acquisitions and Mergers*, in May 1993 and this was followed by FRS 6, with the same title, in September 1994. We shall explore these attempts at standardisation after we have distinguished between the 'acquisition' and 'merger' methods of accounting.

Acquisition and merger accounting

As stated above, the acquisition method has traditionally been used to account for business combinations in the UK and, where the consideration for shares or assets purchased is wholly cash or loan stock, this is agreed to be the correct method of accounting. However, where the consideration given is wholly or predominantly ordinary shares, many accountants would argue that the acquisition method is inappropriate. Here the shareholders in one company exchange their equity holding in that company for an equity interest in another company: a holding company if shares are purchased, or an enlarged company if net assets are purchased. In such circumstances, use of the acquisition method frequently produces inconsistencies in the treatment of the two combining companies. These inconsistencies are avoided by the use of the merger method but, as we shall see, consistency is obtained only at a price.

Under acquisition accounting, an investment in a subsidiary would normally be recorded at the fair value of the consideration given. Where the fair value of any shares issued exceeds their par value, a share premium account or merger reserve would normally be created in the parent company's financial statements.³ In the consolidated financial statements, the investment would be replaced by the underlying separable assets and liabilities of the subsidiary at their fair values, representing their 'cost' to the group. Any difference between the cost of the investment and the sum of the values of the separable assets and liabilities is recorded as goodwill. Pre-acquisition profits of the subsidiary are no longer available for distribution and the results of the new subsidiary are only brought into the consolidated profit and loss account from the date of acquisition.⁴

Under the merger method of accounting, the investment in the subsidiary company would normally be recorded in the parent company's financial statements as the aggregate of the nominal value of any shares issued plus the fair value of any other consideration.⁵ Thus,

³ The conditions for the creation of a merger reserve, rather than a share premium account, will be discussed below.

⁴ The acquisition method of accounting is considered in much greater depth in the next chapter. FRS 7 *Fair Values in Acquisition Accounting*, September 1994, provides guidance both on identifying assets and liabilities at the date of acquisition and on determining their fair values.

⁵ As we shall see later in the chapter, any consideration other than equity shares must be a 'small' proportion of the total consideration for the use of merger accounting to be permissible.

the carrying value of the investment would not be equal to the fair value of the consideration given and no share premium account or merger reserve would be created.

In the consolidated financial statements, the investment would be replaced by the underlying separable assets and liabilities, not at fair value, but at their book values in the subsidiary's own accounts subject to adjustments necessary to achieve consistency of accounting policies for the group.⁶ The pre-acquisition profits of the new subsidiary are not frozen but are aggregated with those of the parent company, and the results of the new subsidiary are brought into the consolidated profit and loss account for the whole period as if the companies had always been merged. No goodwill is recorded and any difference between the nominal value of shares issued plus the fair value of any other consideration given and the nominal value of shares purchased is treated as an adjustment to 'other reserves' in the consolidated financial statements. FRS 6 also makes it clear that any share premium account or capital redemption reserve in the subsidiary's balance sheet should also be treated as a movement in 'other reserves' (Para. 18).

The following illustration demonstrates the essential differences between the two methods when there is a share-for-share exchange.

Summarised balance sheets			
	1	2	3
	<i>Before combination</i>	<i>After combination</i>	
		<i>Acquisition method</i>	<i>Merger method</i>
<i>H Limited</i>	£	£	£
Net assets (Fair values £1800)	1600	1600	1600
Shares in S Limited – at 'cost'	<u> </u>	<u>2400</u>	<u>800</u>
	<u>1600</u>	<u>4000</u>	<u>2400</u>
£1 ordinary shares	1000	1800	1800
Share premium/merger reserve		1600	
Retained profits	<u>600</u>	<u>600</u>	<u>600</u>
	<u>1600</u>	<u>4000</u>	<u>2400</u>
 <i>S Limited</i>			
Net assets (Fair values £1500)	<u>1200</u>	<i>No change</i>	
£1 ordinary shares	800	<i>No change</i>	
Retained profits	<u>400</u>		
	<u>1200</u>		

Column 1 shows the summarised balance sheets of H Limited and S Limited before a combination in which H buys the shares in S in a share-for-share exchange. In order to concentrate on the essential differences between the two methods, we will assume that the current value of a share in both H Limited and S Limited is agreed to be £3. Hence H issues 800 shares in exchange for the 800 shares in S. We shall also assume that the sum of the fair values of separable net assets in H and S are £1800 and £1500, respectively.

⁶ It would, of course, be possible for these assets and liabilities to be revalued. Indeed it would be possible to revalue the assets and liabilities of both of the merging companies, and we discuss this possibility later in this section.

Columns 2 and 3 show the parent company's balance sheet using the principles of the acquisition method and merger method respectively.⁷

If the acquisition method is used, the shares issued by H will be valued at their fair value at the date of issue, that is at £3 per share. The investment in the subsidiary will be shown at a cost of £2400 while a share premium or merger reserve of £1600 will be recorded. Column 2 of the summarised balance sheets reflects these entries.

If the merger method is used, the shares issued by H will be valued at their par value and the investment in the subsidiary will be shown at a 'cost' of £800. This is shown in column 3 of the summarised balance sheet.

We may now prepare the consolidated balance sheet of H Limited and its subsidiary S Limited using the acquisition and merger methods respectively.

Consolidated balance sheet of H Limited and subsidiary S Limited

	1	2
	<i>Acquisition method</i>	<i>Merger method</i>
	£	£
Net assets: H 1600 + S 1500	3100	
H 1600 + S 1200		2800
Goodwill on consolidation		
2400 – 1500	900	
	4000	2800
£1 ordinary shares	1800	1800
Share premium/Merger reserve	1600	
Retained profits: H only	600	
H + S		1000
	4000	2800

Column 1 shows the consolidated balance sheet immediately after the combination using the acquisition method. In preparing the consolidated balance sheet the excess of the cost of investment in the subsidiary (£2400) over the sum of the fair values of the separable assets and liabilities (£1500) is shown as goodwill on consolidation. The effect of using this method may be summarised as follows:

- (a) *Retained profits.* Before the combination H had retained profits of £600 and S had retained profits of £400. However, the consolidated balance sheet only includes the retained profits of H and those of S have been frozen. Thus, if H receives a dividend from the pre-acquisition profits of S, this normally reduces the carrying value of the investment. The dividend received cannot be used as the basis for a dividend payment to the shareholders in H.
- (b) *Net assets.* While the net assets of H are shown on the basis of their book values (£1600), those of S are included at their fair values (£1500).

⁷ This is not strictly correct in that the treatment of the investment in the parent company's financial statements is legally independent of what method of accounting is used in the consolidated financial statements. Thus, if merger relief (see p. 371 later in section) is available, H does not have to create a share premium/merger reserve in its own financial statements even though such a merger reserve will be required to apply acquisition accounting in its consolidated financial statements. What we have done is logically consistent with the subsequent treatment of the combination in the consolidated financial statements.

(c) *Goodwill*. The goodwill in the consolidated balance sheet relates to S. None appears in relation to H.

Many would question whether this gives a true and fair view of the combination. After all, exactly the same people are interested in the net assets after the combination as before, although their proportionate interests will probably have changed as a result of the bargaining process. All that has happened is that the shareholders in S have exchanged their shares in S for shares in H, which now in turn owns S. Thus, two sets of shareholders have come together for their mutual benefit. Why then should the retained profits of one company be frozen while those of the other are not? Why should the net assets of one company be shown at fair values while those of the other are shown at their historical cost values? Why should we recognise goodwill for one company but not for the other?

A further criticism could be made of the method in that the consolidated balance sheet would look very different if, instead of the acquisition of shares in S by H, S had acquired the shares of H. This is a perfectly feasible alternative means of combination. The results produced will therefore vary depending upon what may in fact be an arbitrary choice of the holding company.

Consideration of questions like these has led to the development of merger accounting. Under the merger method, shares issued in exchange for other shares are valued not at their fair value, but at their par value. Thus, using our simple example, the 800 shares issued by H would be valued at £1 each, that is £800, rather than at £3 each. Correspondingly, the investment in S would be shown at a 'cost' of only £800. Column 3 of the summarised balance sheets (p. 368) reflects this entry.

Column 2 of the consolidated balance sheets provides the resulting consolidated balance sheet. From this it may be seen that the pre-combination retained profits of the two individual companies are still available for dividend while the net assets of both companies are shown at their historical-cost-based valuation. It is as if the companies had been combined since the cradle and it follows that, in preparing the consolidated profit and loss account, the results of both companies would be included for the whole year irrespective of the date on which the combination occurred.⁸ In preparing the consolidated financial statements, necessary adjustments must, of course, be made to reflect uniform accounting policies throughout the group.

While the use of the merger method results in a consistent treatment of the profits and net assets of the two companies, it does, of course, have the result that all the assets are valued on the basis of old historical costs, which are arguably of little relevance to users of the financial statements. Under the acquisition method, the assets of at least one company are shown at their fair values at the date of the combination, and to move from such a position to one where all assets are shown on the basis of their historical costs to the separate companies is regarded by some accountants as a step in the wrong direction.

One way to avoid this consequence of merger accounting would be for both companies to restate the carrying values of the separable assets and liabilities at their fair values at the date of combination so that the assets and liabilities of both companies would be shown on a consistent basis at fair value rather than at out-of-date values. Such a method, known as the 'new entity', 'new basis' or 'fresh start' method, has not found favour with standard setters in the past, although the IASB has been exploring the possible use of this method of accounting in Phase II of its review of business combinations, discussed later in this chapter.

⁸ This is to be contrasted with the position using the acquisition method of accounting where the consolidated profit and loss account will only include the results of a new subsidiary from the date of acquisition. This topic is considered in some detail in the following chapter.

In the above example the par value of the shares issued by H was the same as the par value of the shares purchased. In most combinations this will not be the case and, in addition, the consideration may include cash and loan stock. Any difference between the par value of the shares issued plus the fair value of any other consideration and the par value of the shares purchased and any share premium account in respect of these shares would be dealt with as a movement on the consolidated reserves.

We have now explored the differences between acquisition accounting and merger accounting. Provided shares are used to purchase shares or net assets in another company, so that two sets of shareholders have an interest in the resulting combined business, we have the theoretical possibility of applying the merger method of accounting. We shall now explore the way in which the use of such a method has been regulated by some of the official pronouncements.

Development of an accounting standard

The Companies Act 1981

Prior to the Companies Act 1981, there were severe doubts about the legality of the merger method of accounting. Although the ASC had issued ED 3 *Accounting for Acquisitions and Mergers* in 1971, it was unable to make progress in this area until the passage of the Companies Act 1981.

The Companies Act 1981 relieved companies from the need to create a share premium account in certain circumstances and these provisions are now contained in the Companies Act 1985, ss. 131–134. This so-called merger relief is available when one company issues equity shares to purchase equity shares in another company and ends up with an equity holding of 90 per cent or more. In such circumstances, the company does not have to create a share premium account in respect of either the equity shares issued or any non-equity shares issued in exchange for non-equity shares.⁹

Thus, if one company issues equity shares to acquire 95 per cent of the equity shares of another company, it is not necessary to create any share premium account in respect of that transaction. If, however, one company already holds 20 per cent of the equity shares in another company and then purchases an additional 75 per cent of those shares, the relief from the need to create a share premium account applies only to the equity shares issued to obtain the 75 per cent holding, that is the purchase which takes the total holding to 90 per cent or above.

The main consequence of the above provisions was that they permitted, although they did not require, the use of merger accounting.

Once the merger method had been legalised, the ASC was able to turn its attention to the circumstances in which this method should be used. Before we look at the provisions of SSAP 23 (April 1985) and its successor FRS 6 (September 1994), we shall examine some of the matters which had to be considered and resolved.

Criteria for use of the merger method

Use of merger accounting would seem to offer certain advantages where there is a uniting of interests, that is where the equity shareholders in two separate companies pool their interests to become equity shareholders in a combined entity.

⁹ Relief from the requirement to create a share premium account is also provided in the case of certain group reconstructions which involve the transfer of ownership of a company within a group (Companies Act 1985, s. 132).

As described above, the Companies Act 1981 made changes that allowed, but did not require, the use of the merger method, provided at least 90 per cent of the equity shares of the acquired company were part of the pool or, to put it another way, even when up to 10 per cent of the equity shares did not become part of the pool. Within this legal framework, the ASC had to decide what conditions were necessary for the use of the merger method of accounting and whether, if those conditions were satisfied, use of the merger method should be obligatory or optional. In this section some of the factors that had to be considered are discussed briefly.

First, although there must be a uniting of interests, to what extent is it necessary to obtain the approval of the two sets of shareholders? Do all the shareholders in the two companies have to agree to the merger or only some minimum proportion? The law requires the holding in the offeree company to exceed 90 per cent but it says nothing about obtaining the agreement of the shareholders in the offeror company. Clearly it would be possible to impose much more stringent conditions here.

Second, there is the question of relative size. If one company is much smaller than the other then, even though all shareholders in both companies agree to a uniting of interests, the end result may well be a situation in which one set of shareholders is dominant in the combined entity, with the other set of shareholders having insignificant influence. Is this really a uniting of interests or merely an 'acquisition' using equity shares as the consideration?

Third, in order for there to be a uniting of interests, the consideration must be equity shares. If the consideration is wholly cash or loan stock, resources leave the combining businesses and one set of shareholders ceases to have any equity interest in the combination and there is definitely no uniting of interests. A difficulty arises where the consideration consists mainly of equity shares but also partly of cash or loan stock. Does this disqualify the combination for treatment as a merger? If it does not do so in principle, then what is the maximum percentage of the consideration that may be given in a form other than equity shares?

These were the main questions to be answered in specifying the circumstances in which merger accounting could be used, although, as we shall see, the Companies Act 1989 has subsequently restricted the proportion of non-equity consideration that may be included in the total consideration. Given the nature of the questions, answers can only involve arbitrary choice and hence it is not surprising that the selection of a suitable set of criteria has posed problems for standard-setting bodies in the UK and elsewhere.

The approach of SSAP 23

SSAP 23 permitted the use of merger accounting where a number of conditions were satisfied.¹⁰ If we concentrate on a situation in which two companies are combining by forming a holding company/subsidiary company relationship and we assume that both companies have only voting equity shares in issue, these conditions may be summarised in the following way:

- (i) Any initial holding of one company in the other could not exceed 20 per cent.
- (ii) The offer had to be made to all remaining shareholders and had to result in a total holding of 90 per cent or more.
- (iii) Not less than 90 per cent of the fair value of the total consideration given for shares, both in the present transaction and in past transactions, had to be in the form of voting equity shares.¹¹

¹⁰ SSAP 23, Para. 11.

¹¹ As we shall see below, this last condition has been tightened considerably by the Companies Act 1989, which requires that the fair value of any consideration other than equity shares must not exceed 10 per cent of the nominal value of equity shares issued.

Where the initial holding exceeded 20 per cent, there was a presumption, albeit rebuttable, of significant influence requiring the use of the equity method of accounting. The equity method, discussed in Chapter 15, is based on the principles of acquisition accounting and is therefore incompatible with the use of merger accounting.

The requirement that the total holding is 90 per cent or more was necessary to comply with the Companies Act condition for the use of merger relief, and the final condition that 90 per cent or more of the fair value of the total consideration was in the form of voting equity shares limited the non-share consideration to 10 per cent. Hence, a limit was imposed on the resources leaving the group.

The SSAP 23 conditions did not require the combination to be approved by the shareholders in the offeror company nor did it concern itself with the relative sizes of the two companies. Even when all the conditions were satisfied, the use of merger accounting was not compulsory: acquisition accounting could still be used.

The inclusion of these conditions in SSAP 23 led to a number of difficulties and they were superseded by new conditions for the use of merger accounting, inserted in the Companies Act 1985 by the Companies Act 1989.¹² We shall explore these difficulties and provisions before turning to the later thinking of the standard setters as embodied in FRS 6. They provide an excellent example of the difficulties which may arise when accounting standards contain detailed rules rather than principles.

Experience of SSAP 23

If we compare the consequences of using acquisition accounting and merger accounting in our simple example above, it is not hard to see why a company may prefer to use the merger method, if it is available, for a particular business combination. Under the merger method, the balance sheet figures for separable net assets are lower, and no amount emerges for goodwill. Subsequent reported profits will be higher, as depreciation will be based on lower asset values and there will be no goodwill to amortise. Thus, the merger method will result in the reporting of higher returns on capital employed in the company's subsequent financial statements than would be disclosed if the acquisition method were used.

Given the desire of companies to report their affairs in the best possible light, it is perhaps not surprising that numerous attempts were made to exploit the conditions included in SSAP 23 in order to be able to apply merger accounting. Let us look at a few examples.

Under SSAP 23 it was not possible to use merger accounting if the purchasing company held 20 per cent or more of the equity shares in the other company immediately prior to the offer. Where one company held more than 20 per cent in the other, it was easily able to reduce the holding below 20 per cent by 'warehousing' shares with a banker or other third party. Thus, by temporarily selling enough shares to take the holding below 20 per cent and buying them back in the general offer, it was able to satisfy this particular condition.

Other rather blatant exploitations of the specific conditions were the so-called 'vendor placing' and 'vendor rights' schemes. These were used where one company wished to buy shares in another for cash, or some other non-equity share consideration, but also wished to use merger accounting. A payment in cash would mean resources leaving the group and would require the use of acquisition accounting. In order to avoid this, some companies made a share-for-share exchange but gave the shareholders in the acquired company the power to convert the shares which they received into cash immediately, either by placing them with a third party or by selling them back to the shareholders in the acquiring company. The former was a vendor placing and the latter a vendor rights scheme. The end result

¹² Companies Act 1985, Schedule 4A, Para. 10.

was that shares had been purchased for cash but in such a way that merger accounting could be used. While no resources left the group, there was certainly no pooling or uniting of shareholders' interests of the two companies!

It is quite clear that some companies applied the letter rather than the spirit of the standard and the above perceived abuses of the standard brought much criticism from commentators.

FRS 6 Acquisitions and Mergers

Following the Companies Act 1989, which implemented the EC Seventh Directive on consolidated accounts, conditions for the use of merger accounting have been incorporated in the law, and these conditions differ somewhat from those included in SSAP 23. This change, together with the criticisms discussed above, necessitated a revision of SSAP 23.

The legal conditions for the use of merger accounting are contained in Schedule 4A to Companies Act 1985 and are listed in Table 13.2.¹³

Although the conditions in Table 13.2 do not fix a maximum shareholding immediately prior to the combination, condition 3, that the fair value of any non-equity consideration does not exceed 10 per cent of the nominal value of the shares issued, is much stricter than the SSAP 23 condition that it did not exceed 10 per cent of the fair value of the total consideration given. Whereas the purpose of the SSAP 23 condition was clear, the new legal condition appears to lack any economic validity whatsoever.

Table 13.2 Legal conditions for use of merger accounting

- | | |
|---|--|
| 1 | At least 90 per cent of the nominal value of the relevant shares in the undertaking acquired is held by or on behalf of the parent company and its subsidiary undertakings. |
| 2 | The proportion referred to in condition 1 was attained pursuant to an arrangement providing for the issue of equity shares by the parent company or one or more of its subsidiary undertakings. |
| 3 | The fair value of any consideration other than the issue of equity shares given pursuant to the arrangement by the parent company and its subsidiary undertakings did not exceed 10 per cent of the nominal value of the equity shares issued. |
| 4 | Adoption of the merger method of accounting accords with generally accepted accounting principles or practice. |

Condition 4 leaves it to the standard setters to specify any further criteria for the use of merger accounting, and their thinking can now be found in FRS 6 *Acquisitions and Mergers*, issued in September 1994.

The approach taken in FRS 6 owes much to the Canadian standard setters¹⁴ and restricts drastically the circumstances in which merger accounting may be used. The objective of the standard (Para. 1) makes this quite clear:

to ensure that merger accounting is used only for those business combinations that are not, in substance, the acquisition of one entity by another but the formation of a new reporting entity as a substantially equal partnership where no party is dominant; to ensure the use of acquisition accounting for all other business combinations; and to ensure that in either case the financial statements provide relevant information concerning the effect of the combination.

¹³ Schedule 4A, Para. 10. Schedule 4A was inserted into the Companies Act 1985 by Schedule 2 to the Companies Act 1989.

¹⁴ See Canadian Institute of Chartered Accountants (CICA) Handbook, s. 1580, 'Business Combinations', 1973.

The relative sizes of the combining entities, considered unimportant in earlier definitions, now become extremely important in the FRS 6 definition of a merger:

A business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders of the combining entities come together in a partnership for the mutual sharing of the risks and benefits of the combined entity, and in which no party to the combination in substance obtains control over any other, or is seen to be dominant, whether by virtue of the proportion of its shareholders' rights in the combined entity, the influence of its directors or otherwise.

The standard (Paras 6–12) then lists five criteria for determining whether this definition of a merger is met and these are summarised in Table 13.3. Where these criteria are met, merger accounting is compulsory. In all other circumstances, except certain group reconstructions, acquisition accounting must be used.

Table 13.3 Criteria used to identify a merger

-
- 1 No party is portrayed as acquirer or acquired by the board or management of either party.
 - 2 All parties participate in selecting the management structure and personnel of the new entity by consensus rather than purely by the exercise of voting rights.
 - 3 The relative sizes of the combining entities are not so disparate that one party dominates the combined entity.
 - 4 Equity shareholders in the combining entities receive, as consideration, primarily equity shares in the combined entity. Any non-equity consideration must be an immaterial proportion of the fair value received. As we have seen, the law restricts the non-equity consideration to 10 per cent of the nominal value of the equity shares issued.
 - 5 The equity shareholders in the combining entities must not retain a material interest in the future performance of only part of the combined entity. However, a combining entity may divest itself of a peripheral part of its business and still meet the definition of a merger.
-

Whether the combination is an acquisition or merger, the standard specifies minimum disclosure requirements to enable users to understand the effect of the combination. For all combinations, this disclosure must include the names of the combining entities, the date of the combination and whether merger accounting or acquisition accounting has been used.

When merger accounting has been used, the required disclosure includes an analysis of the principal components of the profit and loss account and statement of total recognised gains and losses into amounts related to the merged entity after the date of the merger and, for each party to the merger, amounts relating to that party for the period up to the date of the merger. Comparative amounts for the preceding financial year are also required. The standard also requires disclosure of the aggregate book values of the net assets of each party at the date of the merger and any adjustments made to these to achieve consistency of accounting policies between the parties as well as a statement of the adjustments made to consolidated reserves.

Few business combinations meet the criteria for the existence of a merger laid down in FRS 6 and hence the use of merger accounting is now extremely rare. As always, most business combinations will be acquisitions and the appropriate method of accounting will be acquisition accounting, as discussed in Chapter 14.

The international accounting standard

The relevant international accounting standard, IAS 22 *Business Combinations*, first issued in 1983 and subsequently revised in 1993 and 1998, is yet again under review. This standard distinguishes between two different types of combination, an acquisition and a uniting of interests, and specifies different methods of accounting for each of these. A uniting of interests only occurs when an acquirer cannot be identified¹⁵ and is equivalent to what the ASB describes as a merger. All other business combinations are classified as acquisitions. Where there is an acquisition, the purchase method of accounting must be used. This is essentially the acquisition method as specified in FRS 6. However, when it comes to the detail of how the method is to be applied we find that there are numerous differences between the two standards. We shall examine some of these differences in the following chapter and provide just one example here.

In order to arrive at the initial values of assets and liabilities in an acquired entity, IAS 22 provides a choice between a *benchmark* treatment and an *allowed alternative* treatment. The difference between them is the way in which the share of any minority interest is valued.¹⁶ Under the benchmark treatment, the proportion of the identifiable assets and liabilities in the acquired company which have been purchased are shown at their fair values while the proportion held by any minority interest are shown on the basis of their pre-acquisition carrying values. Under the allowed alternative treatment, the whole of the assets and liabilities of the acquired entity are shown at their fair values and the minority interest is shown at the appropriate proportion of those fair values. The benchmark treatment provides some rather odd numbers in a balance sheet and seems unlikely to survive the present review of IAS 22. However, until this happens, FRS 6 sensibly requires the use of the allowed alternative treatment, rather than the benchmark treatment, of IAS 22.

Where there is a uniting of interests, then the 'pooling of interests' method of accounting must be used. This is the same as the merger method of accounting specified in FRS 6.

While FRS 6 is consistent with, although somewhat more restrictive than, the provisions of IAS 22 on business combinations, there has recently been a movement towards the abolition of the merger/pooling of interests method of accounting. The group of international standard setters G4+1 issued a Position Paper in 1998 and this was subsequently published as a Discussion Paper by the ASB.¹⁷ This paper considers whether there should be a single method of accounting for business combinations and, if so, what it should be. It comes to the conclusion that the purchase method, that is the acquisition method of accounting in British terminology, should be used for all business combinations.

The IASB is reviewing IAS 22 and has divided its review into two phases. The first phase is concerned with such matters as the definition of a business combination and appropriate methods of accounting, including the initial measurement of identifiable assets and liabilities and the treatment of provisions relating to the termination or reduction of the activities of the acquiree. This phase of the review is also concerned with accounting for goodwill, both positive and negative, and intangible assets, which reflects the wide coverage of the international accounting standard.

The second phase of the review is concerned with a number of matters including the way in which the acquisition method of accounting is to be applied and the possible use of the

¹⁵ See IASC Standing Interpretations Committee, Interpretation SIC-9, *Business Combinations – Classification either as Acquisitions or Uniting of Interests*, 1998.

¹⁶ See Chapter 14, p. 430.

¹⁷ G4+1 Position Paper, 'Recommendations for Achieving Convergence on the Methods of Accounting for Business Combinations', FASB, 1998, and Discussion Paper, *Business Combinations*, ASB, London, December 1998.

new basis/fresh start method of accounting for business combinations under which the assets and liabilities of both parties are stated at their fair values, although probably only for those involving entities under common control. It is also looking at the treatment of contingent consideration and contingent assets and liabilities existing in the acquired entity at the date of the combination.

This two-phase review will, in due course, lead to the issue of exposure drafts and then to at least one International Financial Reporting Standard to replace IAS 22. At the time of writing, the IASB is very much in favour of abolishing the pooling of interests method of accounting, which would make life somewhat simpler for hard-pressed students of accounting. However there has been strong opposition to that stance by a number of countries, particularly Japan, and we must await the final outcome of the IASB deliberations.

The authors would welcome the abolition of the pooling of interests/merger method of accounting on both theoretical and practical grounds and await further developments in this area with interest.

Goodwill

Introduction

Goodwill is the term used by accountants to describe the difference between the value placed on a firm and the sum of the fair values of the assets and liabilities of the firm which are identified and recognised by the accounting system. There are two reasons why these values will not be equal. First, most firms possess not only the predominantly tangible assets listed in a balance sheet but also such intangible assets as 'managerial ability', 'efficient staff' and 'regional monopoly' which contribute to the value of the firm and yet are not included in a balance sheet. Second, there is the simple economic fact that assets operating together frequently have a much higher value than the sum of the values of those same assets operating separately.

Goodwill is usually only recorded in an accounting system when a company purchases an unincorporated business or acquires a subsidiary or associated undertaking and prepares consolidated accounts. In the former case the goodwill arises in the accounts of the purchasing company itself whereas, in the latter case, the goodwill arises only in the consolidated accounts. In both cases the goodwill is described as 'purchased goodwill' to distinguish it from internally generated goodwill.

In the past goodwill was sometimes calculated as the difference between the price paid and the sum of the book values of the individually identified assets less liabilities in the books of the acquired firm or company. Although this may simplify calculations, it makes little economic sense, as the values in the books of the acquired firm or company are irrelevant in determining the historical cost of assets to the acquiring company or group. In accounting for an acquisition it is necessary for the acquiring company or group to value the individual assets and liabilities at their fair values, which determine their historical cost to the acquiring company or group.¹⁸ Thus, the total cost of the collection of net assets, tangible and intangible, must be apportioned between those assets and liabilities which are to be identified

¹⁸ See Companies Act 1985, Schedule 4A, Para. 9, which requires the use of fair values when a subsidiary is acquired, and FRS 9, Para. 31(a), which requires a similar treatment in the case of an associate or joint venture. FRS 7 *Fair Values in Acquisition Accounting* (September 1994), specifies standard accounting practice in relation to both the identification of assets and liabilities at the date of acquisition and their valuation. We discuss this topic in Chapter 14.

separately in the accounting system and those which are not so identified. The latter group are recorded in the accounting system as a balancing figure which is described as goodwill. Such goodwill will normally be positive, but FRS 10 *Goodwill and Intangible Assets*, takes the view that it may be negative.¹⁹ This may occur when the price paid for the collection of net assets is less than the sum of the fair values of the separable net assets, although the standard warns us that, where such negative goodwill emerges, the amounts allocated to the separable net assets should be reviewed to ensure that their fair values have not been overstated.

Internally created goodwill is not recorded, whereas goodwill which results from a market transaction is. It is therefore important to recognise that when a goodwill figure appears in a set of financial statements, it does not relate to the whole reporting entity but merely to one segment which has been acquired by purchase.²⁰ Once the purchase has been made, that segment may be merged with the other assets of the enlarged entity and will then no longer be separately identifiable.

With this background we may proceed to examine the problem of accounting for goodwill, assuming for the most part that the goodwill figure is positive.

Accounting for goodwill

Some possibilities

At the date of acquisition, goodwill represents the cost of acquiring certain intangible assets. In such a case, the accruals concept would seem to dictate that the cost should be carried forward and matched against revenues of the periods expected to benefit from the use of such intangible assets. However, the future benefits may be extremely uncertain and there may be no way of determining which benefits arise from the particular collection of intangible assets. Hence, the prudence convention would appear to be relevant and would mean that no asset should be recognised; rather that the amount paid for goodwill should be written off.

Given that there is a conflict between the accruals and prudence conventions, it is not surprising to find that various methods of accounting for goodwill have been proposed. If we ignore the impractical suggestion that goodwill for the whole entity be revalued on each balance sheet date, the various proposals may be summarised as follows:

- (a) Retain goodwill at cost, unless there is a permanent fall in the value.
- (b) Write off (amortise) the cost of goodwill over a period of years, which could be (i) its useful life, or (ii) a specific number of years, or (iii) its useful life subject to a maximum number of years.
- (c) Write off goodwill immediately against reserves.

Some writers have argued that, in view of the unique nature of goodwill, the amount under (a) or (b) should appear, not as an asset, but as a 'dangling debit', that is as a deduction from share capital and reserves. This treatment can be regarded as a 'half-hearted' adoption of options (a) or (b) in that the information is provided but in such a way as to cast doubt upon its relevance.

¹⁹ Many accountants would not admit this possibility, arguing that the price paid must place a ceiling on the sum of the 'costs' of the separable net assets. See the later section of this chapter on the IASB position.

²⁰ An exception to this general position occurs when the net assets of one firm are purchased by a newly formed entity. An example is the conversion of a sole tradership or partnership into a limited company. Provided the limited company acquires only the net assets of the firm and owns no other assets, the goodwill figure will relate to the whole business.

Let us look at each of the proposals in turn.

The retention of goodwill at cost would seem to be justified only if the asset has an indefinite life. It is expected that this would rarely be true in the case of the particular intangible assets purchased, although the purchased benefits may, of course, be replaced by subsequent activities. If the intangible assets acquired do not have an indefinite life, it is necessary to recognise the possibility of a fall in the value of goodwill, but the determination of whether or not such a permanent fall has occurred will be an extremely difficult, if not impossible, task. It will certainly be difficult where the segment of the business which gave rise to the goodwill is no longer separately identifiable.

The amortisation of goodwill over a period of years is also subject to difficulties. In the first case, it is usually very difficult, if not impossible, to determine the useful life of goodwill, a residual category of assets measured by a balancing figure. In the second case, the selection of a specific number of years such as 5 or 40 is merely arbitrary, although the selection of a long period has the advantage that the results of no one period are significantly affected. The third case merely combines the difficulty of the first with the arbitrariness of the second.

The third proposal recognises that, after the year of acquisition, the retention of a goodwill figure relating to part of the business is unlikely to provide information useful to those interested in the affairs of the entity. It therefore requires its removal from the balance sheet by an immediate write-off against reserves.

In view of the different proposals which have been made and their associated problems, it is not surprising that standard setters have experienced considerable difficulty in deciding upon an appropriate standard accounting practice.

The approach of SSAP 22

SSAP 22 *Accounting for Goodwill*, was issued in December 1994 and revised in July 1989. It was replaced by FRS 10 *Goodwill and Intangible Assets*, which we discuss below, in December 1997.

Unless it was prepared to use the true and fair override, the retention of goodwill at its cost was not an option available to the ASC in drafting the original SSAP 22. The Companies Act 1985 stated clearly that, where goodwill is treated as an asset, it must be amortised systematically over a period not exceeding its useful economic life.²¹ However, this still left the possibility of amortisation or of immediate write-off of goodwill against reserves for, in the latter case, goodwill is not treated as an asset and hence the legal requirement for amortisation does not apply.

While SSAP 22 preferred companies to write off goodwill immediately against reserves, it also permitted them to capitalise goodwill and to amortise it in arriving at the profit or loss on ordinary activities.²² Both methods could be used simultaneously in respect of different acquisitions.

The preferred method had two major advantages. First, it avoided the difficult task of estimating the useful life of goodwill. Second, it resulted in a consistent treatment of purchased goodwill and internally-generated goodwill. Given that the law does not permit companies to include internally-generated goodwill in their balance sheets, the write-off of purchased goodwill results in the consistent position that no company shows goodwill in its balance sheet.

A major bias with the above requirements was that, if goodwill was capitalised and amortised, future profits and earnings per share would be reduced, whereas, if goodwill was written off against reserves, there would be no impact on the profit and loss account at all!

²¹ Companies Act 1985, Schedule 4, para. 21.

²² SSAP 22, Paras 32–5.

Not surprisingly the vast majority of companies adopted the preferred method of accounting under SSAP 22, often taking some pretty extreme steps to be able to do so.

Experience of SSAP 22

Before we explore the ways in which companies responded to SSAP 22, it will, perhaps, be helpful if we illustrate how large goodwill may be in relation to the other net assets of a company at the date of acquisition. A good, but extreme, example was provided in the annual accounts of Saatchi and Saatchi Company plc, a consultancy firm, for the year to 30 September 1986. The prices paid for subsidiaries, the tangible net assets acquired, and the resulting goodwill in respect of that year were as follows:

	£m
Cost of acquisitions	443.2
Net tangible assets	<u>41.2</u>
Goodwill	<u><u>402.0</u></u>

Another example is provided in the annual financial statements of Thorn EMI plc for the year to 31 March 1993, a year in which Thorn EMI plc acquired the Virgin Music Group Limited from Richard Branson:

	<i>Total</i>	<i>Virgin Music Group Ltd</i>	<i>Other</i>
	£m	£m	£m
Cost of acquisitions	653.7	593.0	60.7
Fair value of net assets acquired	<u>17.3</u>	<u>14.1</u>	<u>3.2</u>
Goodwill	<u><u>636.4</u></u>	<u><u>578.9</u></u>	<u><u>57.5</u></u>

In both of these cases, goodwill dwarfed the identifiable net assets, as might be expected in any successful company or group where people are the most important assets.

Given that large amounts have been paid to acquire valuable goodwill, there was a considerable reluctance among many companies to write off that goodwill in accordance with SSAP 22. One response was to isolate an element of goodwill as 'brands' and to retain this in the balance sheet.²³ Such an approach raised considerable controversy and, in ED 52 *Accounting for Intangible Fixed Assets* (May 1990), the ASC attempted to outlaw separate accounting for brands. We shall examine the approach of the ASB later in this chapter.

Once faced with the need to account for goodwill in accordance with SSAP 22, it is perhaps not surprising to find that the vast majority of companies chose immediate write-off rather than amortisation through the profit and loss account with its consequent impact on earnings per share. The way in which many large companies did so makes interesting reading.

If a company wished to adopt the policy of immediate write-off, the first question which had to be answered, on which SSAP 22 was silent, was which reserves could be used for the purpose of writing off goodwill. There was widespread agreement that the balance on the profit and loss account and any merger reserve could be used for this purpose, but there was

²³ Some companies have gone further than this by including the values of internally generated brands as well as those which have been purchased. Good examples of companies which accounted for brands are Rank Hovis McDougall and Grand Metropolitan.

dispute over whether the law permitted the use of a revaluation reserve. Although there was a large body of opinion to the effect that a revaluation reserve could not be used for this purpose, many companies chose to ignore this opinion.²⁴

The next problem arose when the 'available' reserves were too small to absorb a write-off of goodwill, and here we found two major responses.

Some companies effectively used share premium accounts to write off goodwill. They applied to the courts for a reduction of capital in order to be able to comply with the preferred method of accounting under SSAP 22. The share premium accounts were effectively relabelled, perhaps as a special reserve, thus becoming available to absorb the goodwill write-off.²⁵

The second response was to create an appropriate reserve, a 'goodwill write-off' reserve, with a zero balance. The purchased goodwill could be written off against this goodwill write-off reserve resulting in a debit balance, a negative reserve, which was deducted from the share capital and reserves in the consolidated balance sheet.²⁶

As well as provoking the above responses, the preference of SSAP 22 for immediate write-off appears to have had certain other consequences. By understating the fair values of the identifiable assets and liabilities, groups have been able to increase the amount labelled as goodwill and, given that this goodwill is written off to reserves, future reported profits benefited from reduced depreciation charges on the identified tangible and intangible assets purchased.

Particular variants of this have involved the creation, at the date of acquisition, of a provision for reorganisation costs and sometimes even a provision for future losses. Such provisions reduce the identified net assets and again increase the goodwill written off against reserves. They are then available to absorb costs which would otherwise have to be charged to the profit and loss account, and any unused amount could, in due course, be credited to the profit and loss account. Although it is possible to justify the setting up of such provisions, some groups have undoubtedly set up excessive provisions. As we have seen in Chapter 7, FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*, now outlaws this approach as does FRS 7 *Fair Values in Acquisition Accounting*, to which we return in the following chapter.

It was developments such as those outlined above which caused the ASC to issue a revised version of SSAP 22 in July 1989. The purpose of this standard was not to change the practice of accounting for goodwill, but to provide additional disclosure to help the users of accounts to understand what had been done.²⁷ Thus companies were required to show how goodwill had been dealt with and to provide the table, subsequently required by law, showing the book values and fair values of each major category of assets and liabilities, together with an explanation of reasons for differences. In addition, it required disclosure of movements on provisions related to acquisitions and of information relating to the treatment of disposals of previously acquired businesses or business segments.

Even as the revised SSAP 22 was being issued, the accounting treatment of goodwill was under review and this led to the very different proposals in ED 47 *Accounting for Goodwill*, which was published in February 1990.

²⁴ Since the Companies Act 1989, the revaluation reserve is definitely not available for the write-off of goodwill, Companies Act 1985, Schedule 4, Para. 34.

²⁵ Examples of companies which employed such an approach are Saatchi and Saatchi in 1985 and 1986 and Blue Arrow plc in 1987. A capital redemption reserve could presumably also be used in this way.

²⁶ Examples of groups which used this 'dangling debit disclosure' are Erskine House Group plc and TI Group plc.

²⁷ The additional disclosure requirements were contained in Paras 47–53 of the revised standard.

Towards a new standard

ED 47 took a very different view from SSAP 22. Whereas SSAP 22 favoured immediate write-off and permitted amortisation, ED 47 removed any choice and proposed that all goodwill should be amortised over its useful economic life. Whereas SSAP 22 attempted to achieve consistency between the treatment of purchased goodwill and that of non-purchased goodwill, ED 47 attempted to achieve consistency between the treatment of goodwill and that of other purchased intangible and tangible fixed assets. So, because buildings, machinery and trade marks are depreciated over their useful economic lives, it was argued that goodwill should be amortised.

ED 47 therefore proposed that positive goodwill should be amortised through the profit and loss account over its useful economic life using the straight-line basis or any other systematic basis which is more conservative and considered to give a more realistic allocation. However, it added the proviso that the useful economic life should not exceed 20 years, except in rare circumstances, and that the maximum life, even in those rare circumstances, should never exceed 40 years. These are provisions we do not find in standards dealing with tangible fixed assets! However, in common with similar provisions in respect of tangible fixed assets, ED 47 envisaged that there should be an annual review to ensure that the carrying value of goodwill was not excessive.

The exposure draft admitted the possibility of negative goodwill although, should such goodwill arise, it proposed a review of the fair values ascribed to the 'identifiable' assets and liabilities. Any negative goodwill remaining after such a review was to be credited to the profit and loss account over a suitable period.

The accounting treatment of goodwill proposed in ED 47 was very different from the preferred treatment of SSAP 22 adopted by the vast majority of UK companies. Given the potential impact of the proposed approach on reported profits, it is perhaps not surprising that there was considerable opposition to ED 47 and, partly due to the demise of the ASC, it was never converted into an accounting standard. As we shall see, the subsequent proposals of the ASB are rather more sophisticated, although we shall argue that the resulting standard, FRS 10 *Goodwill and Intangible Assets*, suffers from spurious sophistication.

ASB pronouncements

It was not until December 1993 that the ASB produced its first discussion paper on this subject entitled *Goodwill and Intangible Assets*.

In its proposed treatment of intangible assets the discussion paper was clear: purchased intangible assets, such as brands, should be subsumed within purchased goodwill and accounted for accordingly, although purchased legal rights, such as patents, attaching to internally created intangible benefits should be capitalised at their historical cost and amortised appropriately (Paras 1.7 and 3.1.3).

When it turned to the subject of accounting for purchased goodwill there was much less certainty. The paper identified the six methods of accounting for goodwill shown in Table 13.4. Three methods involved the recognition of goodwill as an asset while three methods involved the elimination of goodwill.

Although the discussion paper provided extensive discussion of the merits and demerits of the various methods, it failed to identify any single proposed approach. Indeed it identified two very different approaches which had support among Board members, namely methods A3 and B2 or B3. Method A3 is itself a combination of A1 and A2, while methods B2 and B3 both involve the creation of a separate goodwill write-off reserve, either with (B3)

Table 13.4 Methods of accounting for goodwill

A Asset-based methods

- 1 *Capitalisation and amortisation over a predetermined life* subject to a maximum number of years, possibly 20, and subject to the usual test of recoverability at the end of each year.
 - 2 *Capitalisation and annual review.* Under this approach, the value of goodwill is assessed at each balance sheet date using certain ‘ceiling’ tests described at length in Appendix A to the Discussion Paper. These involve comparing the present value of the cash flows from the relevant segment of the business with the sum of the fair values of the separable assets and liabilities of that segment to determine the value of goodwill. Amortisation through the profit and loss account is only necessary if the value so determined is less than the existing carrying value of the goodwill.
 - 3 *Combination of 1 and 2* with 1 being the norm and 2 being used when the goodwill has an indeterminate life expected to be more than 20 years.
-

B Elimination methods

- 1 *Immediate write-off against reserves*, the preferred method of SSAP 22.
 - 2 *Creation of a separate goodwill write-off reserve* with disclosure as a ‘dangling debit’, a deduction from share capital and reserves. Under this approach no further adjustment would be made to the goodwill write-off reserve unless the acquired segment of the group to which it relates is disposed of or closed.
 - 3 *Variant of 2* involving creation of a separate goodwill write-off reserve but with an annual assessment of recoverability to ensure that the goodwill write-off reserve is reduced if the value of the goodwill has fallen permanently.
-

or without (B2) a recoverability test. In other words, the Board envisaged possible ways forward which might have been described by a cynic as anything other than the preferred method of SSAP 22 – B1!

It came as no surprise that no consensus emerged in the responses to the discussion paper, although there was considerable opposition to the proposal that all intangible assets should be subsumed within purchased goodwill. To move matters forward, the ASB issued a working paper in June 1995 entitled ‘Goodwill and Intangible Assets’ for discussion at public hearings, the first such hearings to be held in the UK. This working paper and associated public hearings paved the way for the issue of FRED 12 *Goodwill and Intangible Assets*, in June 1996, and FRS 10, with the same title, in December 1997.

FRS 10 Goodwill and Intangible Assets

The ASB follows the provisions of company law by specifying that purchased goodwill should be capitalised and shown on the face of the balance sheet or consolidated balance sheet while internally generated goodwill should not be capitalised.

It requires that an intangible asset purchased separately should be capitalised at its cost while an intangible asset acquired as part of a purchase of a business should only be capitalised separately from goodwill if its fair value can be measured reliably; otherwise such an intangible should be subsumed within the amount shown for purchased goodwill.

On the purchase of a business, the amount of purchased goodwill will therefore be calculated as the difference between two values:

	£
Price paid to acquire business	X
less Sum of fair values of assets and liabilities identified and to be recorded separately in the accounting system, including intangible assets which can be measured reliably	X
	<u> </u>
Purchased goodwill, including intangible assets which cannot be measured reliably	<u> </u>

We will deal first with the normal situation where purchased goodwill is positive and turn to negative goodwill later in the chapter.

FRS 10 is clear that, when purchased goodwill is positive, it must be recorded in the balance sheet as an intangible fixed asset. While most accountants would accept this position without question, it does pose considerable problems for an ASB which has issued a *Statement of Principles for Financial Reporting* specifying that a balance sheet should only include as assets, items which meet its definition of assets. (See Chapter 1, pp. 17–18.) The ASB is of the view that purchased goodwill does not meet its own definition of assets so has to wriggle somewhat to justify the inclusion of purchased goodwill in a balance sheet or consolidated balance sheet. Paragraph (b) of the Summary of FRS 10 says it all:

The accounting requirements for goodwill reflect the view that goodwill arising on an acquisition is neither an asset like other assets nor an immediate loss in value. Rather, it forms the bridge between the cost of an investment shown as an asset in the acquirer's own financial statements and the values attributed to the acquired assets and liabilities in the consolidated financial statements. Although **purchased goodwill is not in itself an asset** [authors' emphasis], its inclusion among the assets of the reporting entity, rather than as a deduction from shareholders' equity, recognises that goodwill is part of a larger asset, the investment, for which management remains accountable.

The need for such a justification casts some doubt on the theoretical soundness of either the requirement for capitalisation of purchased goodwill or, more persuasively, the *Statement of Principles* itself.

Having required the capitalisation of purchased goodwill, the standard then attempts to ensure that 'capitalised goodwill and intangible assets are charged to the profit and loss account in the periods they are depleted' (Para. 1(a)). In the view of the ASB, such depletion only occurs 'to the extent that the carrying value of the goodwill is not supported by the current value of the goodwill within the acquired business' (Summary Para. (e)). We shall argue that this approach is fundamentally unsound.

In spite of these general principles, the ASB envisages that in practice goodwill and intangible assets will be amortised over their useful economic lives. Recognising the inevitable subjectivity, some would say impossibility, involved in estimating such lives and the potential desire of directors to overestimate them in order to minimise the amortisation expense in the profit and loss account, the standard contains a presumption that the useful economic life of purchased goodwill and intangibles does not exceed 20 years. The presumption is rebuttable so the standard accepts that the useful economic life may exceed 20 years and even that it may, in some cases, be indefinite so that no amortisation will be necessary. The grounds for adopting a life greater than 20 years must be clearly explained and, where an indefinite life is envisaged, the company must disclose the fact that it is invoking the true and fair override and explain why it is doing so.

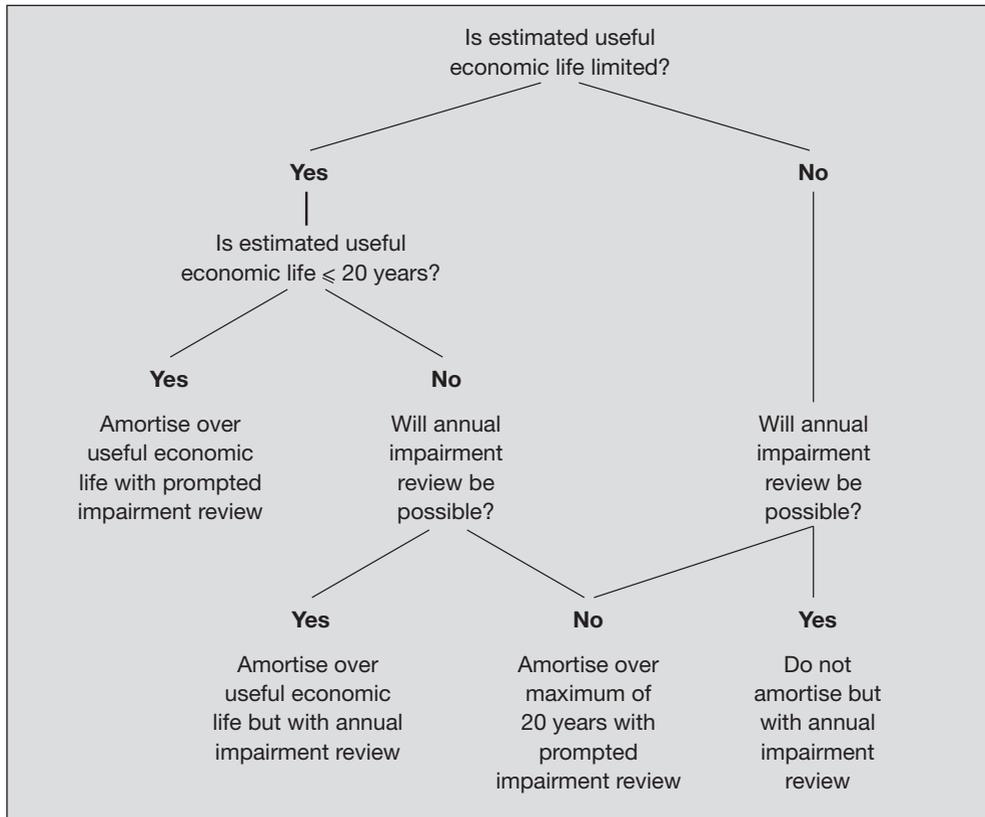


Figure 13.2 Treatment of positive goodwill and intangibles

In accordance with the provisions of FRS 11 *Impairment of Fixed Assets and Goodwill*, which we have explored in the context of tangible and intangible fixed assets in Chapter 5, it is necessary to ensure that the carrying values of goodwill and intangible assets do not exceed their recoverable amounts. This necessitates an impairment review but FRS 10 identifies two different triggers for an impairment review. One is when the estimated useful life is expected to exceed 20 years, in which case an impairment review must be conducted every year. When the estimated useful life is 20 years or less, an impairment review is required at the end of the first full financial year following the initial recognition and subsequently, if events or changes in circumstances indicate that its carrying value may not be recoverable in full. We shall describe the latter as a ‘prompted’ impairment review. Figure 13.2 summarises the requirements of FRS 10.

Impairment reviews

Company law requires that provision be made for the diminution in value of any fixed asset when the diminution in value is expected to be permanent. Such impairment occurs when the recoverable amount of an asset falls permanently below its carrying value and, as we have seen in Chapter 5, FRS 11, *Impairment of Fixed Assets and Goodwill*, attempts to standardise accounting practice in this area. As we shall demonstrate, it is usually more difficult to conduct an impairment review for goodwill than it is for other assets.

As we have explained, FRS 11 distinguishes between what we have described as a prompted impairment review and an annual impairment review but the conduct of the review is the same. To conduct an impairment review it is necessary to compare the carrying value of an asset with its recoverable amount. Recoverable amount is defined as shown in Figure 13.3.

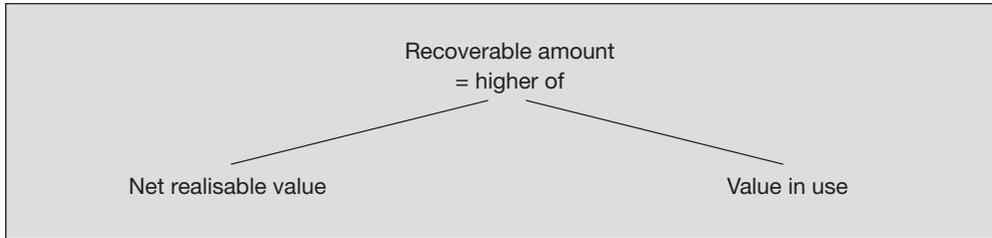


Figure 13.3 Recoverable amount

Net realisable value is the proceeds which would be received from selling an asset less any direct selling costs, while the value in use is the present value of the estimated future cash flows which the asset is expected to produce. As we have seen in Chapter 5, the major problem of applying such reviews in practice is that it is rarely possible to estimate the cash flows produced by a single asset because cash flows are produced by groups of assets used in conjunction with one another. FRS 11 therefore proposes that impairment reviews be undertaken for the smallest group of assets, defined as an income generating unit, which produce a largely independent income stream. In the case of purchased goodwill, the income generating unit is the business acquired which gave rise to the purchased goodwill and, as we shall see, this introduces conceptual and practical problems of a high order.

Let us assume first that the business acquired is not merged in any way with the business of the acquiring company but, rather, that it remains a separately identifiable business unit. According to FRS 11, an impairment review would require a comparison of the value of the acquired business on a subsequent balance sheet date with the sum of the carrying values of the assets and liabilities, including purchased goodwill, relating to that business unit on that same date. Provided the value of the business exceeds the sum of the carrying values there is no impairment whereas, if the reverse is the case, impairment must be recognised by writing down relevant assets.

If impairment on this basis has occurred then, if there is evidence that there is an impairment of any specific asset, that asset should be written down. Otherwise the impairment should be allocated as follows:

- (a) first, to any goodwill in the unit;
- (b) thereafter, to any capitalised intangible asset in the unit; and
- (c) finally, to the tangible assets in the unit, on a pro rata or more appropriate basis.

(FRS 11, Para. 48)

Thus the more subjective values are written down first.

In our view, this approach is fundamentally flawed because the value of the business unit on any balance sheet date subsequent to the date of acquisition will reflect both goodwill created internally since the date of acquisition and any unrecognised gains and losses on the separable assets and liabilities shown in the balance sheet.

Let us explore this point in an example by supposing that a wholly owned subsidiary was acquired on 1 January 1993 and that it still exists as a separately identifiable unit 10 years later on 31 December 2002. Positive purchased goodwill of £90 000 was recognised on acquisition

and this is being amortised on a straight-line basis over 30 years. To conduct an impairment review on 31 December 2002 it would be necessary to value the investment in the subsidiary, usually by discounting the expected future cash flows of the subsidiary, and to compare this value with the sum of the carrying values of assets and liabilities of the subsidiary plus the carrying value of the purchased goodwill:

	£000	£000
Value of investment in subsidiary – say		500
less Sum of carrying values:		
Separately identified assets		
and liabilities – say	400	
Purchased goodwill		
(90 000 – 10(3000))	<u>60</u>	
		<u>460</u>
Surplus		<u><u>40</u></u>

On the basis proposed by FRS 11, there is no impairment on the grounds that the carrying value of the purchased goodwill is supported by the current value of the goodwill within the acquired unit on 31 December 2002. However, the value of the investment on 31 December 2002 reflects goodwill generated internally since 1 January 1993 as well as any unrecognised gains and losses in respect of the tangible assets and liabilities. Let us suppose that we were to revalue the separately identified assets and liabilities to produce a sum of £420 000, rather than £400 000, and that we were able, in some magical way, to value the goodwill generated internally since acquisition at £50 000, the position would be as follows:

	£000	£000
Value of investment in subsidiary		
– as before		500
Sum of current values of separately		
identified assets and liabilities	420	
Carrying value of purchased goodwill	60	
Value of internally generated goodwill		
not recognised	<u>50</u>	
		<u>530</u>
Impairment		<u><u>(30)</u></u>

Given relevant information, there has clearly been an impairment and the carrying value of purchased goodwill should be written down by £30 000, from £60 000 to £30 000.

The FRS 11 approach fails completely to pick this up.

We are not suggesting for one moment that this alternative approach is feasible but, rather, illustrating why the ASB approach fails to identify whether or not impairment has occurred.

In addition to this fundamental flaw, there is a further problem. It will often be the case that an acquired business, for which purchased goodwill has been recognised, will be merged with other businesses of the acquirer. This would mean that the acquired business unit would no longer be identifiable at a subsequent balance sheet date. Although a sensible accountant might be tempted to recognise this as a clear example of a situation where an impairment review was impossible, the ASB attempts to provide a means of conducting a review in such circumstances and also provides us with a fall-back position.

Let us suppose that A plc acquired an unincorporated business B on 1 January 1993 and recognised purchased goodwill of £300 000, which is being amortised on a straight-line basis over its estimated useful life of 30 years. Let us also assume that the net assets of A plc and B have subsequently been merged to produce one income generating unit. How is it possible to conduct an impairment review after 10 years on 31 December 2002?

Using the approach promulgated in FRS 11, we would first have to estimate the internally generated goodwill in A plc at the date of acquisition, 1 January 1993; we will assume that this was £600 000. On 31 December 2002, we would then have to value the income generating unit, A plus B, and compare this value with the sum of the carrying values of the assets and liabilities in the balance sheet, which include purchased goodwill, together with the unrecognised internally generated goodwill which we have estimated, suitably amortised. If we assume that an appropriate amortisation method for the internally generated goodwill in A plc is straight line over, say, 20 years, then the calculation might run as follows:

Impairment review on 31 December 2002		
	£000	£000
Value of income generating unit (A + B)		2000
– say		2000
Sum of carrying values of separately identified assets and liabilities	1900	
Purchased goodwill in B, less amortisation (£300 000 – [10 × £10 000])	200	
Unrecognised goodwill in A, less amortisation (£600 000 – [10 × £30 000])	300	
		2400
Impairment		(400)

FRS 11 requires that this impairment be allocated on a pro-rata basis to purchased and internally generated goodwill:

	£000
Impairment allocated to:	
Purchased goodwill $200/(200 + 300) \times £400\,000$	160
Unrecognised goodwill $300/(200 + 300) \times £400\,000$	240
	400

Only the amount allocated to purchased goodwill would be recognised in the financial statements. So the carrying value of purchased goodwill would be reduced by £160 000, from £200 000 to £40 000, and this amount would be charged to the profit and loss account.

While these calculations give the appearance of precision, the numbers produced are subjective and arbitrary and fundamentally flawed. Both the estimation of the internally generated goodwill in A plc on 1 January 1993 and the valuation of the income generating unit on 31 December 2002 are difficult tasks. But, even if reasonable estimates of these can be made, the approach suffers from the fundamental conceptual error that the valuation of the income generating unit on 31 December 2002 includes both unrecognised valuation changes in individual assets and liabilities as well as goodwill generated internally between 1 January 1993 and 31 December 2002.

While the ASB makes reference to extensive consultation and field testing of such impairment reviews, the conceptual and practical problems of conducting such reviews appear to

be immense. We therefore take some consolation in the fall-back position that, where goodwill is not capable of continued measurement so that annual reviews are not feasible, the goodwill should be amortised over a maximum period of 20 years.

Even this suffers from conceptual problems. Where the expected useful economic life of goodwill does not exceed 20 years, what we have described as a prompted impairment review may become necessary. Such impairment reviews are necessary 'if events or changes in circumstances indicate that the carrying values may not be recoverable'. In an extreme situation where events or circumstances indicate that the value of the goodwill is zero, there will be no problem. However, in a less extreme situation, the FRS 11 approach puts us in an impossible position: an expected life not exceeding 20 years has been selected because it is impossible to conduct an impairment review but then an event or change of circumstances triggers the need for such a review! The logic of the ASB proposals here leaves much to be desired.

Purchased goodwill is the term used by accountants to describe a residual category of assets measured by a balancing figure. Given the difficulty of estimating the useful economic life of such a creature and the virtual impossibility of conducting sensible impairment reviews, we shall not be at all surprised to find that most companies amortise their positive purchased goodwill over a period of 20 years. Whatever they do, amounts attributed to goodwill in financial statements are likely to be rather short on economic meaning.

Negative goodwill

Let us turn next to the subject of negative goodwill, which occurs when the sum of the fair values of the individual assets and liabilities recognised on acquisition exceed the cost of the acquisition.

Given that accountants use fair values to determine the historical cost to the new owner of the individual assets and liabilities recognised at the date of acquisition, many accountants would argue that there can be no such phenomenon as negative goodwill. This is certainly the position taken by Accounting Principles Board (APB) Opinion 16 in the USA, which makes it absolutely clear that the sum of the 'costs' of the individually identified assets and liabilities cannot exceed the cost of the business or investment purchased. Where negative goodwill appears on an initial calculation, APB Opinion 16 requires that the recorded costs of the non-monetary assets be reduced to eliminate that goodwill. In our view, this is the only approach which is compatible with the use of historical cost accounting.

Neither FRS 10 nor the international accounting standard IAS 22 accepts this strict historical cost approach. The ASB envisages situations where negative goodwill may arise as, for example, when a bargain purchase has been made or where future reorganisation costs must be incurred consequential upon the acquisition but these costs do not satisfy the criteria for recognition as provisions at the date of acquisition. Where such negative goodwill emerges, the standard exhorts us to look more closely at the values attributed to the identified assets and liabilities to see whether these should be amended.

Once having permitted, indeed required, the recognition of negative goodwill, FRS 10 then has to confront the problem of how to account for it. The standard takes the view that negative goodwill should be shown next to positive goodwill among the assets in a balance sheet and that it should be recognised through the profit and loss account over the period when the non-monetary assets acquired are used or sold. Given that there will probably be a large collection of non-monetary assets with varying lives, the determination of this relevant period is beset with problems and is bound to be arbitrary. As with positive goodwill, any figure which appears in a profit and loss account or balance sheet in respect of negative goodwill is almost certain to lack any economic meaning whatsoever.

Disclosure requirements

FRS 10 requires substantial disclosures concerning positive goodwill, negative goodwill and intangible assets. We have not attempted to summarise this disclosure but rather direct readers to the relevant paragraphs of FRS 10, namely Paras 52 to 64.

The international accounting standards

There are a number of international standards relevant to the treatment of goodwill, namely:

- IAS 22 *Business Combinations* (revised 1998 and, at the time of writing, under review again);
- IAS 36 *Impairment of Assets* (1998); and
- IAS 38 *Intangible Assets* (1998).

IAS 38 prohibits the recognition of internally generated goodwill as an asset. IAS 22 requires that purchased goodwill should be recognised and accepts that it may be positive or negative.

Positive goodwill must be recognised as an asset and amortised, on a systematic basis, over its useful economic life. As under FRS 10, there is a rebuttable presumption that the useful economic life will not exceed 20 years. However, unlike FRS 10, IAS 22 takes the view that 'the useful life of goodwill is always finite' (Para. 51).

IAS 36 requires impairment reviews similar to those required by FRS 11, and IAS 22 requires that, as a minimum, there must be an annual impairment review when the estimated useful life of goodwill exceeds 20 years.

Like FRS 10, IAS 22 permits the recognition of negative goodwill and lays down rules on whether it should be credited to the income statement immediately or over a period of years equal to the average useful life of the identifiable acquired depreciable or amortisable assets acquired. As under FRS 10, IAS 22 requires the carrying value of negative goodwill to be shown as a deduction from assets under the same balance sheet classification as positive goodwill.

As we have explained in connection with business combinations earlier in the chapter, IAS 22 is under review and the accounting treatment of goodwill and intangibles is being examined in Phase I of that review. At the time of writing, it appears that the IASB will change the accounting treatment of negative goodwill to require it to be credited to the income statement immediately rather than over the average life of the collection of non-monetary assets which existed at the date of acquisition. If this change is made, at least one impossible task will be taken from the shoulders of accountants!

Conclusion

It is easy to be critical of the ways in which standard setters have dealt with goodwill but it is instructive to ponder why they have found the topic difficult and to suggest a different approach to the solution of the problem.

Under the conventional historical cost accounting system, purchased goodwill may be included in balance sheets but internally generated goodwill may not be included. As the ASB wisely points out, every method of accounting for this purchased goodwill is inconsistent with other aspects of financial accounting. If the purchased goodwill is recognised, this is inconsistent with the treatment of internally generated goodwill. If purchased goodwill is eliminated, this is inconsistent with the treatment of other fixed assets. While SSAP 22 preferred the elimination of purchased goodwill, FRS 10 has moved to the other end of the spectrum by requiring the recognition and amortisation of purchased goodwill.

As we have seen, FRS 10 even accepts that goodwill may have an indefinite life. The fundamental question here is whether after, say, 50 years of successful operations, the current

goodwill is the original purchased goodwill or goodwill which has been created in the subsequent period. We have no doubts as to the answer to this question and are extremely sceptical of the view that goodwill can have an indefinite life. We therefore feel more comfortable with the view of IAS 22 that ‘the useful life of goodwill is always finite’.

Even if we confine ourselves to a situation where the expected useful economic life of goodwill is finite, there must be severe doubts about any estimate of the useful economic life of this goodwill which is, after all, computed as a balancing figure representing a residual category of assets not recognised separately in the accounting system. Any estimate of the useful life of such a creature must be both subjective and arbitrary so that any figure for goodwill which appears in a balance sheet or profit and loss account is likely to be lacking in economic meaning.

The ASB seeks to ensure that the carrying value of goodwill does not exceed its recoverable amount but, as we have demonstrated, the FRS 11 approach to impairment reviews is conceptually unsound and may actually result in the inclusion of outlawed internally generated goodwill in the balance sheet in some circumstances.

In our view, the treatment of goodwill will remain an intractable problem while we continue to attempt to force all relevant financial information into an articulated set of financial statements. Even where individual assets and liabilities are shown at their current values, the financial statements of a business do not attempt to provide a valuation of the business. Goodwill usually derives from a past valuation of a part of the business. How can such different approaches possibly be reconciled?

Our preferred solution is quite simple. Given the impossibility of arriving at any meaningful figures for goodwill in the primary financial statements, all goodwill should be written off immediately. However, larger companies should then be required to present a separate statement which summarises and aggregates the current values of the individual assets and liabilities recognised in the financial statements on the balance sheet date and, in addition, provides an estimate of the valuation of the whole business, perhaps based on its market capitalisation. The difference between these two totals provides an indication of the value of goodwill of the company or group on the balance sheet date. Such a figure may be explained and discussed and would seem to sit comfortably with the ASB’s attempt to deflect attention from any one number in the financial statements towards a larger set of relevant information.²⁸ It would also sit comfortably with the attempt to raise the profile of the *Operating and Financial Review*, discussed in Chapter 17.

The value for goodwill would, of course, be highly subjective but the subjectivity would be apparent and such an approach would be far from the spurious accuracy of the figures required by FRS 10.

We find it hard to imagine that FRS 10 will be the final word on accounting for goodwill and intangible assets.

Summary

The first part of the chapter deals with business combinations while the second part deals with the closely related topic of goodwill.

²⁸ As we explain in Chapter 21, a similar approach was proposed in the Discussion Document, ‘Making Corporate Reports Valuable’, Institute of Chartered Accountants of Scotland, Kogan Page, London, 1988. Readers are referred to the proposed ‘Assets and Liabilities Statement’ discussed in Chapter 7 of that report.

In the first part of the chapter, we provided some background on the reasons for business combinations and ways in which they may be effected, using different legal structures and different forms of consideration. We then explored the differences between the acquisition or purchase method of accounting and the merger or pooling of interests method of accounting for combinations. We examined the regulatory frameworks in the UK, as provided by company law and FRS 6, and by the IASB in IAS 22. We explained that the latter is at present under review and that the merger method of accounting, which is already rare, may disappear entirely when the review of IAS 22 is complete.

In the second part of the chapter, we examined the nature of goodwill and explored the possible ways of accounting for such a phenomenon. We then examined the regulatory framework in the UK, as provided formerly by SSAP 22 and now by FRS 10 and FRS 11, as well as the provisions of the relevant IASB standards, including IAS 22. Both the ASB and the IASB now require the amortisation of positive purchased goodwill over its useful economic life but, whereas FRS 10 envisages the possibility of an indefinite life, this is not envisaged by IAS 22. Both the ASB and the IASB accept the possibility of the existence of negative goodwill and lay down similar rules for its treatment.

We cast severe doubts on the rules contained in FRS 10 and FRS 11, particularly those relating to the impairment review, and expressed our concerns as to whether any figure in a set of financial statements purporting to represent goodwill has any economic meaning whatsoever. We have also suggested an alternative approach, one that appears to be in line with current developments concerned to increase and improve the extent of narrative reporting.

Recommended reading

- J.A. Arnold, D. Egginton, L. Kirkham, R.H. Macve and K. Peasnell, *Goodwill and other intangibles*, ICAEW, London, October 1992.
- P. Barwise, C. Higson, A. Likierman and P. Marsh, *Accounting for Brands*, London Business School and ICAEW, London, 1989.
- T.E. Cooke, *Mergers and Acquisitions*, Blackwell, Oxford, 1986.
- T.E. Cooke, *International Mergers and Acquisitions*, Blackwell, Oxford, 1998.
- M.C. Miller, 'Goodwill – an aggregation issue', *The Accounting Review*, April 1973.
- R. Perrier (ed.), *Brand Valuation*, 3rd edn, Interbrand, Premier Books, London, 1997.
- H.R. Schwencke, *Accounting for Mergers and Acquisitions in Europe*, International Bureau of Fiscal Documentation Publications BV, Amsterdam, 2002.
- M.A. Weinberg and M.V. Blank, *Takeovers and Mergers*, Vols 1 and 2, 5th edn by L. Rabinovitz, Sweet and Maxwell, London, 1989. This is published in loose-leaf form and updated regularly. At the time of writing the latest update was Release Bulletin number 25, January 2002.

Questions

- 13.1** 'Accounting standards should narrow differences in reporting yet acquisition accounting and merger accounting result in significantly different results in the year of combination and thereafter.'

You are required to discuss the above statement stating, with reasons, whether there is a need for two different methods.

CIMA, Advanced Financial Accounting, May 1994

(15 marks)

- 13.2** The balance sheets of Left plc and Right plc at 31 December 1999, the accounting date for both companies, were as follows.

	<i>Left plc</i>	<i>Right plc</i>
	£000	£000
Tangible fixed assets	60 000	40 000
Stocks	10 000	9 000
Other current assets	12 000	10 000
Current liabilities	(9 000)	(8 000)
Quoted debentures	<u>(15 000)</u>	<u>(12 000)</u>
	<u>58 000</u>	<u>39 000</u>
Equity share capital (£1 shares)	30 000	20 000
Share premium account	10 000	5 000
Profit and loss account	<u>18 000</u>	<u>14 000</u>
	<u>58 000</u>	<u>39 000</u>

On 31 December 1999, Left plc purchased all the equity shares of Right plc. The purchase consideration was satisfied by the issue of 6 new equity shares in Left plc for every 5 equity shares purchased in Right plc. At 31 December 1999 the market value of a Left plc share was £2.25 and the market value of a Right plc share was £2.40. Relevant details concerning the values of the net assets of Right plc at 31 December 1999 were as follows:

- The fixed assets had a fair value of £43.5 million.
- The stocks had a fair value of £9.5 million.
- The debentures had a market value of £11 million.
- Other net assets had a fair value that was the same as their book value.

The effect of the purchase of shares in Right plc is NOT reflected in the balance sheet of Left plc that appears above.

Requirements

- (a) Prepare the consolidated balance sheet of the Left plc group at 31 December 1999 assuming the business combination is accounted for
- as an acquisition; and
 - as a merger. (14 marks)
- (b) Discuss the extent to which the business combination satisfies the requirements of FRS 6 – *Acquisitions and mergers* for classification as a merger. You should indicate the other information you would need to enable you to form a definite conclusion. (6 marks)

CIMA, Financial Reporting, May 2000

(20 marks)

- 13.3** AB, a public limited company manufactures goods for the aerospace industry. It acquired an electronics company CG, a public limited company on 1 December 1999 at an agreed value of £65 million. The purchase consideration was satisfied by the issue of 30 million

shares of AB, in exchange for the whole of the share capital of CG. The directors of AB have decided to adopt merger accounting principles in accounting for the acquisition, but the auditors have not as yet concurred with the use of merger accounting in the financial statements.

The following summary financial statements relate to the above companies as at 31 May 2000.

Profit and Loss Accounts for the year ended 31 May 2000

	£000	£000
	AB	CG
Turnover	45 000	34 000
Cost of sales	<u>(31 450)</u>	<u>(25 280)</u>
Gross profit	13 550	8 720
Distribution and administrative expenses	<u>(9 450)</u>	<u>(3 820)</u>
Operating profit	4 100	4 900
Interest payable	<u>(200)</u>	<u>(400)</u>
Profit before taxation	3 900	4 500
Taxation	<u>(1 250)</u>	<u>(1 700)</u>
Dividends (proposed)	<u>(250)</u>	<u>—</u>
Retained profit for the year	<u>2 400</u>	<u>2 800</u>

Balance Sheets at 31 May 2000

	£000	£000
	AB	CG
Tangible fixed assets	36 000	24 500
Cost of investment in CG	30 000	—
Net current assets	29 000	17 500
Creditors: amounts due after more than one year	<u>(2 000)</u>	<u>(4 000)</u>
Total assets less liabilities	<u>93 000</u>	<u>38 000</u>
Capital and Reserves		
Ordinary shares of £1	55 000	20 000
Share premium account	3 000	6 000
Revaluation reserve	10 000	—
Profit and loss account	<u>25 000</u>	<u>12 000</u>
	<u>93 000</u>	<u>38 000</u>

The following information should be taken into account when preparing the group accounts:

- (i) The management of AB feel that the adjustments required to bring the following assets of CG to their fair values at 1 December 1999 are as follows:

Fixed Assets to be increased by £4 million;

Stock to be decreased by £3 million (this stock had been sold by the year end);

Provision for bad debts to be increased by £2 million in relation to specific accounts;

Depreciation is charged at 20% per annum on a straight line basis on tangible fixed assets;

The increase in the provision for bad debts was still required at 31 May 2000. No further provisions are required on 31 May 2000.

- (ii) CG has a fixed rate bank loan of £4 million which was taken out when interest rates were 10% per annum. The loan is due for repayment on 30 November 2001. At the date of acquisition the company could have raised a loan at an interest rate of 7%. Interest is payable yearly in arrears on 30 November.
- (iii) CG acquired a corporate brand name on 1 July 1999. The company did not capitalise the brand name but wrote the cost off against reserves in the Statement of Total Recognised Gains and Losses. The cost of the brand name was £18 million. AB has consulted an expert brand valuation firm who have stated that the brand is worth £20 million at the date of acquisition based on the present value of notional royalty savings arising from ownership of the brand. The auditors are satisfied with the reliability of the brand valuation. Brands are not amortised by AB but are reviewed annually for impairment, and as at 31 May 2000, there has been no impairment in value. Goodwill is amortised over a 10 year period with a full charge in the year of acquisition.
- (iv) AB incurred £500 000 of expenses in connection with the acquisition of CG. This figure comprised £300 000 of professional fees and £200 000 of issue costs of the shares. The acquisition expenses have been included in administrative expenses.

Required

- (a) Prepare consolidated profit and loss accounts for the year ended 31 May 2000 and consolidated balance sheets as at 31 May 2000 for the AB group utilising:
 - (i) Merger accounting;
 - (ii) Acquisition accounting. (19 marks)
- (b) Discuss the impact on the group financial statements of the AB group of utilising merger accounting as opposed to acquisition accounting. (Candidates should discuss at least three effects on the financial statements.) (6 marks)

ACCA, Financial Reporting Environment (UK Stream), June 2000 (25 marks)

- 13.4** There are currently two possible methods of preparing consolidated financial statements when two or more separate legal entities combine to form a single economic entity in the form of a group. The most commonly used method is the acquisition method. However, another method is sometimes appropriate when two or more separate legal entities unite into one economic entity by means of an exchange of equity shares. This method is known as the merger method. Recent developments suggest that Standard setters are considering a change that would prevent the merger method ever being used and require that the acquisition method be used to prepare consolidated financial statements following a business combination.

Top plc and Bottom plc are two listed companies that operate in the same sector. The two sets of directors have been speculating for some time that it would be in the mutual interest of the two companies to combine together to form a single economic entity while maintaining the separate legal status of the two companies. Accordingly, on 30 April 2001 Top plc made an offer to all the equity shareholders of Bottom plc to acquire their shares. The terms of the offer were 4 equity shares in Top plc for every 3 equity shares in Bottom plc. The offer was accepted by all the equity shareholders in Bottom plc and the exchange of equity shares took place on 31 May 2001. The directors of Top plc wish to use merger accounting to prepare the consolidated financial statements for the year ended 31 January 2002. Any

computational work in this question should assume that merger accounting principles will be adopted.

The relevant profit and loss accounts and balance sheets of Top plc and Bottom plc are given below:

Profit and loss accounts – year ended

31 January 2002	<i>Top plc</i>	<i>Bottom plc</i>
	£000	£000
Turnover	80 000	75 000
Cost of sales	<u>(40 000)</u>	<u>(38 000)</u>
Gross profit	40 000	37 000
Other operating expenses	<u>(10 000)</u>	<u>(9 000)</u>
Operating profit	30 000	28 000
Investment income	10 000	–
Interest payable	<u>(5 500)</u>	<u>(4 000)</u>
Profit before taxation	34 500	24 000
Taxation	<u>(7 500)</u>	<u>(7 000)</u>
Profit after taxation	27 000	17 000
Dividends paid 30 November 2001	<u>(15 000)</u>	<u>(10 000)</u>
Retained profit	12 000	7 000
Retained profit – 1 February 2001	20 000	18 000
Retained profit – 31 January 2002	<u><u>32 000</u></u>	<u><u>25 000</u></u>

Balance sheets at 31 January 2002

	<i>Top plc</i>	<i>Bottom plc</i>
	£000	£000
Tangible fixed assets	89 000	65 000
Investments – see Note 1 [below]	40 800	–
Net current assets	27 200	25 000
Loans	<u>(25 000)</u>	<u>(20 000)</u>
	<u>132 000</u>	<u>70 000</u>
Called-up share capital – £1 equity shares	84 000	30 000
Share premium account	10 000	11 000
Revaluation reserve	6 000	4 000
Profit and loss account	<u>32 000</u>	<u>25 000</u>
	<u><u>132 000</u></u>	<u><u>70 000</u></u>

Note 1 – investment in Bottom plc

The investment in Bottom plc comprises:

	£000
40 million equity shares issued by Top plc	40 000
Merger expenses (including £500 000 issue costs of shares)	<u>800</u>
	<u>40 800</u>

Note 2 – accounting policies

Both companies have the same accounting policies in all respects other than valuation of stock. Bottom plc uses the LIFO method whereas Top plc uses the FIFO method. The directors of Top plc wish to use the FIFO method in preparing the consolidated financial statements. Details of the stocks of Bottom plc are as follows:

<i>Date</i>	<i>Stock valuation under FIFO</i>	<i>Stock valuation under LIFO</i>
	£000	£000
1 February 2001	9500	9000
31 May 2001	9600	9200
31 January 2002	10200	9300

Note 3

In preparing your answers to this question you should assume that the directors of Top plc wish to maximise the profit and loss reserve that is reported in the consolidated balance sheet.

Required

- Prepare the consolidated profit and loss account of the Top plc group for the year ended 31 January 2002, starting with turnover and ending with retained profit carried forward. Ignore deferred taxation. (5 marks)
 - Prepare the consolidated balance sheet of the Top plc group at 31 January 2002. Ignore deferred taxation. (5 marks)
 - Explain the concepts underpinning acquisition accounting and merger accounting and suggest why merger accounting might be considered invalid. (10 marks)
- CIMA, Financial Reporting – UK Accounting Standards, May 2002* (20 marks)

- 13.5** Growmoor plc has carried on business as a food retailer since 1900. It had traded profitably until the late 1980s when it suffered from fierce competition from larger retailers. Its turnover and margins were under severe pressure and its share price fell to an all time low. The directors formulated a strategic plan to grow by acquisition and merger. It has an agreement to be able to borrow funds to finance acquisition at an interest rate of 10% per annum. It is Growmoor plc's policy to amortise goodwill over ten years.

1. Investment in Smelt plc

On 15 June 1994 Growmoor plc had an issued share capital of 1 625 000 ordinary shares of £1 each. On that date it acquired 240 000 of the 1 500 000 issued £1 ordinary shares of Smelt plc for a cash payment of £164 000.

Growmoor plc makes up its accounts to 31 July. In early 1996 the directors of Growmoor plc and Smelt plc were having discussions with a view to a combination of the two companies.

The proposal was that:

- On 1 May 1996 Growmoor plc should acquire 1 200 000 of the issued ordinary shares of Smelt plc which had a market price of £1.30 per share, in exchange for 1 500 000 newly issued ordinary shares in Growmoor plc which had a market price of £1.20p per share. There has been no change in Growmoor plc's share capital since 15 June 1994. The market price of the Smelt plc shares had ranged from £1.20 to £1.50 during the year ended 30 April 1996.

- (ii) It was agreed that the consideration would be increased by 200 000 shares if a contingent liability in Smelt plc in respect of a claim for wrongful dismissal by a former director did not crystallise.
- (iii) After the exchange the new board would consist of 6 directors from Growmoor plc and 6 directors from Smelt plc with the Managing Director of Growmoor plc becoming Managing Director of Smelt plc.
- (iv) The Growmoor plc head office should be closed and the staff made redundant and the Smelt plc head office should become the head office of the new combination.
- (v) Senior managers of both companies were to re-apply for their posts and be interviewed by an interview panel comprising a director and the personnel managers from each company. The age profile of the two companies differed with the average age of the Growmoor plc managers being 40 and that of Smelt plc being 54 and there was an expectation among the directors of both boards that most of the posts would be filled by Growmoor plc managers.

2. Investment in Beaten Ltd

Growmoor plc is planning to acquire all of the 800 000 £1 ordinary shares in Beaten Ltd on 30 June 1996 for a deferred consideration of £500 000 and a contingent consideration payable on 30 June 2000 of 10% of the amount by which profits for the year ended 30 June 2000 exceeded £100 000. Beaten Ltd has suffered trading losses and its directors, who are the major shareholders, support a takeover by Growmoor plc. The fair value of net assets of Beaten Ltd was £685 000 and Growmoor plc expected that reorganisation costs would be £85 000 and future trading losses would be £100 000. Growmoor plc agreed to offer four year service contracts to the directors of Beaten Ltd.

The directors had expected to be able to create a provision for the reorganisation costs and future trading losses but were advised by their Finance Director that FRS 7 required these two items to be treated as post-acquisition items.

Required

- (a) (i) Explain to the directors of Growmoor plc the extent to which the proposed terms of the combination with Smelt plc satisfied the requirements of the Companies Act 1985 and FRS 6 for the combination to be treated as a merger; and
- (ii) If the proposed terms fail to satisfy any of the requirements, advise the directors on any changes that could be made so that the combination could be treated as a merger as at 31 July 1996. (8 marks)
- (b) Explain briefly the reasons for the application of the principles of recognition and measurement on an acquisition set out in FRS 7 to provisions for future operating losses and for re-organisation costs. (3 marks)
- (c) (i) Explain the treatment in the profit and loss account for the year ended 31 July 1996 and the balance sheet as at that date of Growmoor plc on the assumption that the acquisition of Beaten Ltd took place on 30 June 1996 and the consideration for the acquisition was deferred so that £100 000 was payable after one year, £150 000 after two years and the balance after three years. Show your calculations.
- (ii) Calculate the goodwill to be dealt with in the consolidated accounts for the years ending 31 July 1996 and 1997, explaining clearly the effect of deferred and contingent consideration.
- (iii) Explain and critically discuss the existing regulations for the treatment of negative goodwill. (9 marks)

13.6 FRS 10 – *Goodwill and Intangible Assets* – was issued in December 1997. At the same time, SSAP 22, the previous Accounting Standard which dealt with the subject of accounting for goodwill, was withdrawn. SSAP 22 allowed purchased goodwill to be written off directly to reserves as one amount in the accounting period of purchase. FRS 10 does not permit this treatment.

Invest plc has a number of subsidiaries. The accounting date of Invest plc and all its subsidiaries is 30 April. On 1 May 1998, Invest plc purchased 80% of the issued equity shares of Target Ltd. This purchase made Target Ltd a subsidiary of Invest plc from 1 May 1998. Invest plc made a cash payment of £31 million for the shares in Target Ltd. On 1 May 1998, the net assets which were included in the balance sheet of Target Ltd had a fair value to Invest plc of £30 million. Target Ltd sells a well-known branded product and has taken steps to protect itself legally against unauthorised use of the brand name. A reliable estimate of the value of this brand to the Invest group is £3 million. It is further considered that the value of the brand can be maintained or even increased for the foreseeable future. The value of the brand is *not* included in the balance sheet of Target Ltd.

For the purposes of preparing the consolidated financial statements, the Directors of Invest plc wish to ensure that the charge to the profit and loss account for the amortisation of intangible fixed assets is kept to a minimum. They estimate that the useful economic life of the purchased goodwill (or premium on acquisition) of Target Ltd is 40 years.

Requirements

- (a) Outline the key factors which lay behind the decision of the Accounting Standards Board to prohibit the write-off of purchased goodwill to reserves. (11 marks)
- (b) Compute the charge to the consolidated profit and loss account in respect of the goodwill on acquisition of Target Ltd for its year ended 30 April 1999. (5 marks)
- (c) Explain the action which Invest plc must take in 1998/99 and in future years arising from the chosen accounting treatment of the goodwill on acquisition of Target Ltd. (4 marks)

CIMA, Financial Reporting, November 1999 (20 marks)

13.7 Islay plc has acquired the following unincorporated businesses:

- (1) ‘Savalight’, a business specialising in the production of low-cost, energy efficient light bulbs, acquired on 1 June 1996 for £580 000. The identifiable assets and liabilities of the business had a book value of £550 000 and were valued at £500 000 on 1 June 1996. The company estimated the useful economic life of the goodwill arising at five years and has been amortising this through the profit and loss account. It was anticipated that the goodwill would have a residual value of £20 000.
- (2) ‘Green Goods’, a business specialising in the distribution of a range of environmentally friendly products, acquired on 1 June 1997 for £1.8 million. The identifiable assets and liabilities of the business had a book value of £1.1 million and were valued at £1.3 million on 1 June 1997, including goodwill of the business of £150 000. The company estimated the useful economic life of goodwill arising at 25 years and has been amortising this through the profit and loss account.
- (3) ‘Smart IT’, a business specialising in the distribution of computers, acquired on 1 June 1998 for £900 000. The identifiable assets and liabilities of the business had a book value of £1 million and were valued at £1.2 million on 1 June 1998. Assume the major non-monetary assets in these amounts have a useful economic life of 15 years.

Islay plc revalued its tangible fixed assets during the year ended 31 May 1999 and created a revaluation reserve of £600 000. In addition, the company believes the goodwill arising on

the purchase of 'Savalight' is now worth £350 000 and intends to reflect this in the financial statements for the year ended 31 May 1999.

The company's capital and reserves (**before reflecting any adjustments for the above acquisitions**) in the draft financial statements as at 31 May 1999 show:

Capital and reserves	£000
Called up share capital (5 000 000 ordinary shares of £1 each)	5000
Revaluation reserve	600
Profit and loss account (£200 000 for the year ended 31 May 1999)	700
	<u>6300</u>

Requirements

- (a) Calculate and disclose the amounts for goodwill to be included in the financial statements for Islay plc for the year ended 31 May 1999, providing the following disclosures:

Balance sheet extracts

Disclosure note for goodwill

Disclosure note for movements on reserves.

(13 marks)

- (b) Explain the accounting treatment you have adopted for any goodwill arising in acquisitions (1) to (3) above, referring to the provisions of FRS 10, 'Goodwill and Intangible Assets', and noting any current or future action Islay plc will have to take on goodwill recognised.

(4 marks)

ICAEW, *Financial Reporting, June 1999*

(17 marks)

- 13.8** Elie plc acquired 80% of the £1 million ordinary share capital of Monans Ltd on 1 July 2001 by issuing 200 000 £1 ordinary shares. Elie plc's ordinary shares were quoted at £17 on 1 July 2001. Expenses of the share issue amounted to £90 000.

A further amount of £94 500 is payable in cash on 1 July 2002. Elie plc's borrowing rate is 5%.

A further contingent consideration of shares with a value of £500 000 is dependent on Monans Ltd achieving a 10% increase in turnover in the year ended 31 October 2002. This would become due on 1 July 2003. Monans Ltd has achieved an increase in turnover over the past five years of 11%, 8%, 10%, 11% and 12% (from the earliest to the most recent year).

The net assets of Monans Ltd in its accounts as at 1 July 2001 were £3 million with fair value being £1 million higher than book value. Monans Ltd had the following reserves at 1 July 2001:

	£000
Revaluation reserve	400
General reserve	100
Profit and loss account	1500

A further acquisition of shares took place on 1 September 2001 when Elie plc purchased 60% of the £500 000 preference shares of Monans Ltd for £390 000.

Elie plc is intending to write off any goodwill arising over 9 years, charging a full year in the year of acquisition.

Elie plc has identified the following matters not reflected in the financial statements of Monans Ltd as at 1 July 2001:

- (1) A contingent asset amounting to £200 000 existed at 1 July 2001; the company's lawyers consider it is probable this will be received in the near future.
- (2) Operating losses of £300 000 are expected after acquisition.
- (3) Reorganisation costs of £100 000 are to be incurred to bring Monans Ltd's systems into line with those of the group.
- (4) A fall in stock value of £50 000 on 5 July 2001 due to a fire at a warehouse. The stock now has a net realisable value of £5000.

Requirements

- (a) Calculate the amount of goodwill arising on the acquisition of Monans Ltd that would be shown in the group accounts of Elie plc for the year ended 30 June 2002. (8 marks)
- (b) Explain your calculation of the goodwill arising in (a) including your treatment of items (1) to (4) above, referring to appropriate accounting standards. (12 marks)

ICAEW, *Financial Reporting, June 2002*

(20 marks)

- 13.9** FRS 11 – *Impairment of fixed assets and goodwill* requires that all fixed assets and goodwill should be reviewed for impairment where appropriate and any impairment loss dealt with in the financial statements.

The XY group prepares financial statements to 31 December each year. On 31 December 1998 the group purchased all the shares of MH Ltd for £2 million. The fair value of the identifiable net assets of MH Ltd at that date was £1.8 million. It is the policy of the XY group to amortise goodwill over 20 years. The amortisation of the goodwill of MH Ltd commenced in 1999. MH Ltd made a loss in 1999 and at 31 December 1999 the net assets of MH Ltd – based on fair values at 1 January 1999 – were as follows:

	£000
Capitalised development expenditure	200
Tangible fixed assets	1300
Net current assets	250
	1750
	1750

An impairment review at 31 December 1999 indicated that the value in use of MH Ltd at that date was £1.5 million. The capitalised development expenditure has no ascertainable external market value.

Requirements

- (a) Describe what is meant by 'impairment' and briefly explain the procedures that must be followed when performing an impairment review. (12 marks)
- (b) Calculate the impairment loss that would arise in the consolidated financial statements of the XY group as a result of the impairment review of MH Ltd at 31 December 1999. (4 marks)
- (c) Show how the impairment loss you have calculated in (b) would affect the carrying values of the various net assets in the consolidated balance sheet of the XY group at 31 December 1999. (4 marks)

CIMA, *Financial Reporting, May 2000*

(20 marks)

13.10 Acquirer plc is a company that regularly purchases new subsidiaries. On 30 June 2000, the company acquired all the equity shares of Prospects plc for a cash payment of £260 million. The net assets of Prospects plc on 30 June 2000 were £180 million and no fair value adjustments were necessary upon consolidation of Prospects plc for the first time. Acquirer plc assessed the useful economic life of the goodwill that arose on consolidation of Prospects plc as 40 years and charged six months' amortisation in its consolidated profit and loss account for the year ended 31 December 2000. Acquirer plc then charged a full year's amortisation of the goodwill in its consolidated profit and loss account for the year ended 31 December 2001.

On 31 December 2001, Acquirer plc carried out a review of the goodwill on consolidation of Prospects plc for evidence of impairment. The review was carried out despite the fact that there were no obvious indications of adverse trading conditions for Prospects plc. The review involved allocating the net assets of Prospects plc into three income-generating units and computing the value in use of each unit. The carrying values of the individual units before any impairment adjustments are given below:

	<i>Unit A</i>	<i>Unit B</i>	<i>Unit C</i>
	£ million	£ million	£ million
Patents	5	–	–
Tangible fixed assets	60	30	40
Net current assets	<u>20</u>	<u>25</u>	<u>20</u>
	<u>85</u>	<u>55</u>	<u>60</u>
Value in use of unit	72	60	65

It was not possible to meaningfully allocate the goodwill on consolidation to the individual income-generating units, but all the other net assets of Prospects plc are allocated in the table shown above. The patents of Prospects plc have no ascertainable market value but all the current assets have a market value that is above carrying value. The value in use of Prospects plc as a single income-generating unit at 31 December 2001 is £205 million.

Required

- Explain why it was necessary to review the goodwill on consolidation of Prospects plc for impairment at 31 December 2001. (4 marks)
- Explain briefly the purpose of an impairment review and why the net assets of Prospects plc were allocated into income-generating units as part of the review of goodwill for impairment. (5 marks)
- Demonstrate how the impairment loss in unit A will affect the carrying value of the net assets of unit A in the consolidated financial statements of Acquirer plc. (4 marks)
- Explain and calculate the effect of the impairment review on the carrying value of the goodwill on consolidation of Prospects plc at 31 December 2001. (7 marks)

CIMA, Financial Reporting – UK Accounting Standards, May 2002

(20 marks)