



FINANCIAL REPORTING COUNCIL

FRC STUDY: ACCOUNTING FOR ACQUISITIONS

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One – Introduction

Recent economic conditions have constrained the number of mergers and acquisitions (M&A)¹ undertaken by UK companies. Many are now forecasting a return to more normal levels of transaction activity. The Financial Reporting Council (FRC) has undertaken this study of accounting for acquisitions to assess the quality of acquisition accounting and to see whether there is a need for significant improvement.

Traditionally, companies gave an account of their most significant mergers and acquisitions in the front part of their annual reports to help investors and other annual report users to understand the impact of such transactions. However, the Companies Act 2006 expanded the mandatory content of the business review included in the directors' report. Directors of quoted companies now have to report explicitly, to the extent necessary, on the main factors likely to affect the company's future development which should include the impact of major acquisitions.

Companies frequently expend resources on development, maintenance and enhancement of intangible resources but IFRS prohibits the recording (known as recognition in accounting language) of most internally developed intangible resources. However, IFRS 3 'Business combinations' which was published in 2004 (IFRS 3 2004)² contains specific accounting requirements to be applied to all business combinations. Many UK companies are still developing their understanding of the requirements of this standard.

The most significant difference between IFRS 3 2004 and previous UK financial reporting requirements is that all business combinations (whether mergers or acquisitions) must be accounted for as acquisitions. Changes to the definition of an intangible asset also mean that more intangible assets are likely to have to be recorded separately from goodwill under IFRS. Intangible assets that meet the requirements of IFRS to be reported include items such as brands, trademarks, customer and supplier contracts, licences and intellectual property.

Under IFRS, the value attributed to an asset arising from an acquisition is the amount (known as fair value) for which the asset could be exchanged in a, possibly hypothetical, market that is presumed to exist between a willing buyer and an unrelated willing seller. This requirement is intended to ensure that assets acquired in a business combination are recorded at what they were worth at the acquisition date, thereby giving rise to consistent accounting outcomes regardless of whether assets are acquired as part of an acquisition or separately. These accounting requirements are coupled with significant disclosures about the intangible assets recorded and a requirement to describe the factors giving rise to any goodwill.

¹ M&A activities are referred to in financial reporting standards as business combinations.

² Applicable to UK Listed companies in 2005 and Alternative Investment Market companies in 2007.

During 2008 and early 2009, the FRC conducted a series of interviews with investors and company finance teams in order to understand the factors that made the preparation and use of corporate reports complex and published a discussion paper called 'Louder than words': <http://www.frc.org.uk/publications/pub1995.html>. One element of the feedback received was that companies found merger and acquisition accounting costly and difficult to perform. Moreover, investors said that they did not find the resulting information useful. It was unclear, however, whether this was due to poor application of the requirements, or whether the information provided was not useful even when the accounting requirements had been met.

This study of accounting for acquisitions took place in late 2009 and evaluated 20 acquisitions that had been completed in 2008. All were material to the acquirer. It assessed the quality of the information provided in the business review and the disclosures about individual intangible assets and goodwill recorded in the audited accounts. For example, if it was stated in the business review that a strategic reason for the transaction was to secure substantial new customer contracts, the note to the accounts explaining the intangible assets arising was examined to identify whether customer contracts had been recorded as a significant intangible asset.

The review did not examine other aspects of acquisition accounting.

The FRC is publishing this study to help companies identify areas for improvement in their accounting for acquisitions at a time when the volume of acquisitions is expected to increase significantly.

The FRC intends to conduct further interviews with investors and other stakeholders in 18 months time to assess whether the information about acquisitions has improved in quality and whether such information is useful to them. The FRC will also conduct further work with companies to better understand the challenge of producing reliable data on intangibles and the level of costs incurred. The FRC will provide this feedback to the IASB as part of its planned post-implementation review of IFRS 3 (revised).

Two – Summary of results

The acquisitions selected for the study were all material to the acquiring companies as was the amount of the aggregate of intangible assets and goodwill recorded. In the sample, the value of intangible assets and goodwill recorded was, on average, approximately equal to the purchase price for the acquisition. The aggregate value of intangible assets and goodwill recorded ranged from 30% to 180% of the purchase price for the transactions selected. The significance of these amounts should have led the companies and their auditors to take particular care to ensure that the business review was comprehensive and that the IFRS reporting requirements for acquisitions were met in full.

Overall, the results were disappointing. In some cases it was difficult to identify the required accounts disclosures and in other cases the information provided in the business review and the audited accounts was either insufficient or inconsistent.

Nearly all the companies included in the study gave a logical and seemingly comprehensive account of the reasons and expected benefits of the acquisitions in their business reviews. However, we were able to find a coherent and consistent link between the information in the business review and the intangible assets recorded for only four transactions. Furthermore, we concluded that none of the descriptions of the factors giving rise to goodwill in the audited accounts was informative. This was because more than half the companies either failed to provide any description of goodwill or provided an analysis that was non-descript, i.e. it merely repeated generic terms quoted from IFRS 3 2004 that were not specific to the transaction.

Seven of the companies failed to comply with the IFRS requirement to identify separately the different classes of intangible asset arising from each material transaction. Instead, they identified the classes of intangible asset only in aggregate for all acquisitions during the year. This restricted the ability of the reader of the accounts to understand which classes and amounts of intangible assets arose from individually material acquisitions.

The FRC considers that there is a need for improved compliance with the disclosure requirements of IFRS, so that investors and other stakeholders can better relate the intangible assets recorded for material acquisitions to the account of the transaction given in the business review. A high level of consistency between the information in the business review and the audited accounts would improve the quality and transparency of the information about acquisitions.

The FRC notes that the quality of application of accounting and reporting standards generally improves as market practice develops. It hopes that this short study will be a catalyst for Boards of directors, audit committees, accounting teams and auditors to consider the accounting for acquisitions more carefully. The FRC also notes that other market developments should assist the application of the IFRS requirements in future, including an increase in the knowledge, skills and experience of practitioners in valuing intangible assets, the additional clarifications and guidance contained in IFRS 3 (revised), which applies from July 2009, and the additional guidance on measuring fair value to be published by the IASB and IVSC during 2010.

Three – Review of compliance by area

3.1 Business review commentary on acquisitions

Section 417 of the Companies Act 2006 sets out mandatory requirements regarding the business review to be included in a directors' report. 417.4 states that "...the review required is a balanced and comprehensive analysis of ... the development and performance of the company's business during the financial year ...".

Section 417.5 requires that "...in the case of a quoted company the business review must... include the main trends and factors likely to affect the future development, performance and position of the company's business...".

Nearly all the companies explained well the rationale for their material acquisitions during the period and set out, in the business review, details regarding potential future benefits that they expected to arise.

Common themes included:

- Revenue synergies expected from cross-selling products
- Access to forward order books
- Improved distribution networks
- Strengthened market positions including the acquisition of brand names
- Achieving critical mass in particular locations
- Cost savings from elimination of duplication

The quality of the explanations provided could not be assessed independently without entering into correspondence with the management of these companies, which was beyond the scope of the study. However, the explanations appeared logical and reasonable in the individual circumstances.

3.2 Audited accounts commentary on acquisitions

IFRS 3.66 2004 requires disclosure in the audited accounts of "...information that enables users.... to evaluate the nature and financial effect of business combinations....during the period...".

From the disclosures provided in the audited accounts, there was little evidence that any of the companies had addressed the requirements of IFRS 3.66 2004, although, as noted earlier such disclosures were made in the business reviews. The FRC considers there is little to be gained from repeating disclosures in two different parts of the annual report and accounts. Companies should consider how they might better link the explanations of the rationale for their material acquisitions set out in their business review with the information provided in the audited accounts.

3.3 Recorded intangible assets

IFRS 3.45 2004 requires intangibles to be recorded separately if they satisfy the definition of being identifiable³ and can be measured reliably as required by IAS 38. Identifiable means that intangible assets are either contractually or legally secured or are separable from a business. In turn, separable means that the intangible asset can be sold or licensed without selling the entire business, either alone or together with other tangible or intangible assets.

Two of the companies in the sample recorded no intangible assets other than goodwill, although the explanation for the transactions in their business reviews highlighted several intangible benefits expected from the acquisitions. It was unclear why none of the intangible benefits had satisfied the identifiability criterion of being either legally secured or separable, or whether there had been a problem with reliable measurement of their fair value, and, hence, why such amounts had all been subsumed within goodwill.

³ IFRS 3 2004, which was in effect when the transactions took place included an additional requirement that the fair value of an intangible asset had to be capable of reliable measurement if it was to be recognised – the standard assumed that this was the case for identifiable intangibles arising from acquisitions. However, IFRS 3 (revised) which is effective for accounting periods commencing on or after 1 July 2009, goes a step further by stating that the fair values of all identifiable intangible assets arising from acquisitions can be measured reliably and, hence, there is no longer any test of reliable measurement that is required to be passed, before an intangible asset arising from an acquisition has to be recognised separately from goodwill.

3.4 Reported classes of intangible assets for each material acquisition

IFRS 3.67(f) 2004 requires companies to disclose the amounts recognised for each class of assets acquired in each material acquisition. In relation to intangible assets, IAS 38.119 describes a class of intangible assets as “a grouping of assets of a similar nature and use in an entity’s operations”.

The following table sets out the number of classes of intangible assets reported as arising from the sampled acquisitions:

Number of classes of intangible assets reported	Number of companies reporting this number of classes
1	8
2	4
3	3
4	3
Total	18

Eighteen of the companies identified at least one class of intangible asset arising from their acquisitions during the year. However, seven of the companies had aggregated intangibles arising from a number of material transactions during the year thus failing to comply with the requirements of IFRS 3.67 2004.

3.5 Descriptions of classes of intangible assets

IFRS 3.67 (f) 2004 requires companies to disclose separately each material class of asset that they have acquired in each material business combination. The practical effect of this requirement is that companies need to describe the nature of the individual intangibles they have grouped together.

The companies in the sample described their classes of intangible assets as follows:

Classes of intangible assets recorded	Number reporting the given class
Trade names, brand names, marketing intangibles	8
Customer contracts/order backlog – alone	4
Customer relationships – alone	4
A combination of some or all of: customer contracts, customer lists and customer relationships	3
Technology, patents, intellectual property rights	5
Software	5
Windfarm developments	1
Other	7

The results suggest that companies find it difficult to establish meaningful groups of intangible assets to aggregate as classes in the audited accounts and that greater care is needed to ensure compliance with the disclosure requirements in a meaningful manner.

Customer related intangible assets appeared to cause particular difficulty. Customer related intangible assets were identified for fifteen of the twenty transactions. Only one acquirer, however, had identified the distinct nature of different types of customer related intangible assets and reported more than one class of such assets being customer contracts and, separately, customer relationships.

Customer contracts, customer lists and customer relationships were combined, or partly combined, by three of the companies. However, these different intangibles may provide benefits to companies in different ways and over different periods. Two companies had formed a class of intangible assets from the aggregation of customer relationships and marketing or brand assets, although these two types of intangible benefit are economically dissimilar – one relating to a pool of customers and one relating to a name known in the marketplace⁴. Three companies had pooled customer-related intangibles with other types of intangible asset within an ‘other’ category.

Seven of the companies sampled recognised a category of intangible asset labelled as ‘other’. Three of these had combined a wide range of intangibles in this category. For example, one company combined purchased and acquired patents, licences and trademarks, software rights and licences and an order backlog. This level of aggregation does not satisfy the requirement that any grouping of reported assets should be “of a similar nature and use in an entity’s operations”.

The FRC considers that greater care is required to ensure that adequate disclosure is made of the intangible assets arising from individually material acquisitions and to ensure that material intangible assets with significantly different economic characteristics are not aggregated.

⁴ For presentation purposes, we have included these within the eight companies in the table that recognised a class including trade names, brand names and marketing intangible assets.

3.6 Explanation of what goodwill represents

IFRS 3.67(h) 2004 requires disclosure, for each material acquisition, of the factors that contribute to goodwill, including a description of each intangible asset that is not recorded separately.

Six of the companies failed to provide this required disclosure.

We reviewed the descriptions of goodwill provided in the audited accounts of the remaining 14 companies and assessed whether they appeared to us to be informative, slightly informative or uninformative. The results were as follows:

Classification of goodwill description in audited accounts	Number of transactions
Informative	0
Slightly informative	9
Uninformative	5
Total	14

None of the descriptions of the goodwill arising were genuinely informative. Few companies in the sample described factors specific to the business acquired that gave rise to goodwill or details of intangible assets acquired but which did not satisfy the IFRS requirements for recognition separately from goodwill. For example, reference might have been made to the presence of a team of staff with specific skills or to customer relationships that were not legally secured or separable and hence did not meet the definition of an intangible asset.

Some descriptions of goodwill were 'slightly informative'. We used this classification if the descriptions provided some further information that was specific to the transaction. For example, one company made reference to customer loyalty and the value of the assembled workforce acquired. However, even this company did not identify other components and did not explain why customer loyalty had not been capable of being recorded as an intangible asset.

3.7 Overall consistency between business review and audited accounts

As a final step we assessed the overall consistency between the explanations of the acquisitions in the business review and the amounts reported as classes of intangible assets together with the supporting accounting disclosures.

We were unable to make this assessment for seven of the companies as there was insufficient, or insufficiently disaggregated, information about these material transactions in the audited accounts to support any conclusion.

In relation to the 13 other companies the results were as follows:

Consistency between intangible asset classes recognised in the audited accounts and commentary in the business review	Number of transactions
Consistent	4
Significant inconsistencies	4
Inconsistent	5
Total	13

The disclosures were assessed as 'consistent' if the benefits identified in the business review could be matched to the classes of intangible asset recorded in the balance sheet and the explanation given about goodwill in the notes to the accounts. The disclosures were assessed as containing 'significant inconsistencies' if at least one class of intangible asset apparent from the business review was missing, without explanation, from the classes of intangible asset recorded in the balance sheet or the goodwill explanation in the notes to the accounts.

The disclosures were assessed as 'inconsistent' if none of the benefits identified in the business review could be matched to intangible assets recognised in the balance sheet. For example, the key rationale given about three transactions were, respectively, securing a major distribution contract, possession of a valuable database and acquiring specific brand names. However, none of these were recognised as intangible assets in the audited accounts. We classified one acquisition as inconsistent because customer-related intangible assets had been recorded in the audited accounts, although there was no mention of customer benefits in the business review.

The FRC believes that greater attention needs to be given to ensuring that the information provided in the business review is consistent with the amounts recorded for intangibles and supporting explanations in the audited accounts.

Four – Impact of IFRS 3 (revised) and other new guidance

The acquisitions that were selected for this study all took place during 2008 when IFRS 3 2004 was applicable. IFRS 3 (revised) which applies to annual accounting periods beginning on or after 1 July 2009 includes new guidance on how to apply the separability and the legal-contractual principles inherent in recording individual intangible assets. Perhaps of greater significance is the fact that the revised standard concludes that all intangible assets should be capable of reliable measurement when acquired as part of a business combination. This should lead to a step change in the recording of intangible assets in future audited accounts.

The FRC also notes that the IASB issued an exposure draft on 'Fair Value Measurement' in May 2009 which is expected to be finalised during 2010 and that the International Valuation Standards Council (IVSC) has issued an Exposure Draft addressing the 'Determination of the Fair Value of Intangible Assets for IFRS Reporting Purposes' which is expected to be finalised in early 2010. This additional guidance should facilitate more reliable valuations of intangible assets in respect of future acquisitions.

Appendix I: Amounts of goodwill or other intangible assets as a proportion of consideration paid for equity acquired

The amounts recorded as goodwill or other intangible assets for the sampled transactions were:

Recorded amounts as a proportion of the acquisition consideration	Total recorded goodwill and intangible assets	Recorded goodwill	Recorded intangible assets
0% - 25%	0	2	10
26% - 50%	3	3	4
51% - 75%	1	7	3
76% - 100%	6	5	2
Greater than 100%	10	3	1
Total in the sample	20	20	20
Average proportion for sample	101%	68%	33%

Appendix II: Industries included in the study

The transactions selected for this study were drawn from a wide cross section of industries and included:

1. Aerospace and defence
2. Financial services – 2 companies
3. Industrial engineering – 2 companies
4. Industrial transportation
5. Investment services
6. Logistics
7. Mining
8. Personal products
9. Pharmaceuticals – 2 companies
10. Publishing
11. Software and computer services
12. Support services – 2 companies
13. Telecommunications
14. Tobacco
15. Travel and leisure
16. Utilities



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