Accounting for Negative Goodwill: IFRS 3 versus FRS 102

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Introduction

International Financial Reporting Standards (IFRS) and Financial Reporting Standards (FRS) co-exist in Ireland. Under European Regulation (EC) No.1606/2002, the consolidated financial statements of companies listed on European stock exchanges, such as the Irish Stock Exchange, must be prepared in accordance with IFRS. However, sections 290 and 293 of the Companies Act 2014 allow non-listed Irish companies a choice. This article discusses a potentially significant area of divergence between the requirements of the two sets of accounting standards: accounting for negative goodwill during a business combination.

Business combinations: recognition and measurement

IFRS 3 (Business Combinations) outlines the accounting treatment for the acquisition of a company. The standard permits a number of accounting events at the acquisition date which would not typically be permitted under other IFRSs. The restrictive requirements of the IFRSs are temporarily suspended during a business combination and a considerable amount of leeway is provided to facilitate the recognition and measurement of the assets and liabilities of the subsidiary.

Firstly, the acquirer recognises the identifiable assets, liabilities and non-controlling interests of the subsidiary at acquisition date (para 10). This principle allows the recognition of assets and liabilities that would usually not be permitted under other IFRSs. For example, internally generated intangible assets of the subsidiary, such as a brand name, may be recognised in the financial statements; this accounting treatment would not be permitted under IAS 38 (Intangible Assets) outside of a business combination context.

Secondly, IFRS 3 contains an exception for the recognition of contingent liabilities. At the acquisition date, the acquirer does not apply the requirements of IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) when evaluating the contingent liabilities within the subsidiary. The acquirer may recognise a contingent liability if a present obligation exists from past events and its fair value can be reliably measured. As such, the recognition of a contingent liability does not require a probable future outflow of economic benefits to settle the obligation (para 23).

Finally, the measurement principles outlined in IFRS 3 require that the identifiable assets and liabilities of the subsidiary be measured at their fair values at the acquisition date (para 18). The fair value measurement principle is necessary for the net assets of the subsidiary to be prepared on the same basis as the consideration transferred. This allows for the fair value of the net assets to be compared to the fair value of the consideration transferred to obtain control of the subsidiary.

Goodwill

Goodwill is recognised at the acquisition date when a difference arises between the acquirer's share of the subsidiary's identifiable net assets and the consideration transferred to obtain control of the subsidiary (para 32). IFRS 3's recognition and measurement principles (discussed above) allow a wider range of assets and liabilities to be recognised at fair value, compared to the requirements of the other IFRSs. As a result, (positive) goodwill is the most likely outcome of a business combination: the acquirer pays more than their share of the identifiable net assets of the subsidiary. Logically, if the acquirer didn't pay an excess above the fair value of the net assets being acquired, it would be in the economic interests of the subsidiary's shareholders to refuse the offer and maintain ownership of the company.

The focus of this article is on the accounting treatment for the less frequent scenario: where an acquirer pays a consideration that is lower than their share of the fair value of the net assets of the subsidiary. Under these circumstances, 'negative goodwill' or a 'bargain purchase gain' will be recognised (para 34). An example of when this may occur is a forced sale: when the seller is acting under compulsion. IFRS 3 requires the acquirer to recognise any negative goodwill in the profit or loss on the acquisition date (para 34).

Accounting for negative goodwill under FRS 102

Generally, the accounting treatment for business combinations under FRS 102 conforms to the requirements of IFRS 3. However, one major difference is that FRS 102 requires negative goodwill to be deferred and recognised on face of the statement of financial position. Negative goodwill must be presented immediately below (positive) goodwill and a sub-total of net goodwill provided on the statement of financial position (para 19.24).

Further, FRS 102 requires negative goodwill, up to the fair value of non-monetary assets acquired, to be recognised in the profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to be benefited (para 19.24).

Conclusion

There are major differences in the recognition requirements for negative goodwill in IFRS 3 and FRS 102. IFRS 3 allows the preparer to recognise the entire amount of negative goodwill through the profit or loss on the date of acquisition. In contrast, FRS 102 requires negative goodwill to be deferred on the statement of financial position and gradually released through the profit or loss.

The above differences could have a significant impact on the reported profit or loss figures where the reporting entity has acquired a subsidiary through a forced sale. Under IFRS 3, the full amount of the bargain purchase gain will be recognised through the profit or loss in the period of acquisition. With FRS 102, the gain will be deferred and recognised in the profit or loss in future periods. As previously mentioned, IFRS and FRS co-exist in Ireland and it is important to be aware of areas where the two sets of standards diverge.