From January 2008 firms are likely to find their capital resources reduced, Kieran Marsh tells Andrew Holt, making the need to meet the capital resources requirement all the more important

Goodwill hunting

FSA rules and regulations state that from 14 January 2008, a firm's goodwill will no longer contribute towards its capital resources and must be deducted. This will affect a large portion of the broking community with hundreds of millions of pounds being taken out of the capital resources equation.

Goodwill is the extra paid, over and above the net tangible assets purchased, in the acquisition of a business.

Kieran Marsh, chief executive of Marsh Corporate Consulting, says: "Goodwill created following an acquisition represents a payment made by the acquirer (such as a consolidator or through a management buy-out) in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised."

Goodwill is normally written off through the profit and loss account over periods of up to 20 years. With effect from 1 January 2005, the new International Accounting Standard (IAS 38) on intangible assets allows listed companies to review goodwill on an impairment basis.

Marsh says: "This relates to accounting for goodwill acquired in business combinations for which the agreement date is on or after 31 March 2004. Good practice dictates that a number of firms will also adopt the standard. Firms can look at the composition of goodwill and decide what amounts, if any, should be written off through the profit and loss account. Firms undertaking this exercise will have the benefit of increased profits, leading to greater capital resources."

Retail mediation activities return (RMAR) submissions post 14 January 2008 will need to deduct goodwill from a firm's capital resources.

Study sample

Following an examination of the prevalence of goodwill on a study carried out on a representative sample basis by Marsh Corporate Consulting, the findings confirmed:

1. Goodwill cumulatively amounts to several billion pounds.
2. While many brokers with goodwill continue to satisfy the capital resources requirement, hundreds of brokers could fail post 14 January 2008.
3. Even where authorised firms seem compliant, there are many that may be non-compliant as a result of the FSA's principles for business (PRIN): PRIN 3 – management and controls; PRIN 4 – financial providence; PRIN 11 – relations with regulators. These apply to non-authorised firms and the activities of authorised firms' group and holding companies. Many brokers have made acquisitions where the goodwill has ended up in a group or holding company. These activities could be in contravention of the FSA under PRIN 4 and PRIN 11.
4. Dividend policies do not appear to be structured towards larger amounts of after-tax profits being retained to meet the firm's capital resources requirement post 14 January 2008.

Marsh says: "The consolidation process is accelerating and the consideration multiples make sense. With multiples ranging from

Capital resource requirement

The capital resources requirement required under PRU 9.3.30R and CASS 5.4.4R (4) is as follows:

Not holding client money:
The higher of £5,000 or 2.5% of the annual income

Holding client money:
The higher of £10,000 or 5% of the annual income

Holding client money with retail transactions in a non-stat trust account:
The higher of £50,000 or 5% of the annual income

Under PRU 9.3.21R, a firm must at all times maintain capital resources equal to or in excess of its relevant capital resources requirement.

PRU 9.3.52R is quite specific as to which items are eligible to contribute to the capital resources of a firm.

1. Share capital that must be fully paid.
2. Capital: other – this is mainly relevant to sole traders and partnerships and covers the firms/partnerships current and capital accounts.
3. Reserves – accumulated profits retained (include interim net profits, if audit exempt), share premium accounts and gifts of capital from a parent undertaking.
4. Revaluation reserves.
5. Subordinated loans.

PRU 9.3.53 R states the following must be deducted from the above.

1. Investments in own shares.
2. Intangible assets (including goodwill from 14 January 2008).
3. Interim net losses.
4. Excess drawings greater than profits for a sole trader or partnership.

The FSA's rules and regulations are quite clear as to what the capital resources requirement should be, that it should be met at all times and what items are eligible to meet the capital resources requirement.

one to two times brokerage, goodwill is inevitably created. With good client retention, economies of scale plus deferred consideration, the acquisitions often pay back within a few years."

Many acquisitions stem from a firm's review of its succession planning policies.

Marsh says many brokers have been proactive in recognising the impact of the FSA's stance post 14 January 2008.

"There are good examples of firms combining their goodwill exposure with solid financial plans," he says.

However, Marsh warns, the following points should be carefully considered:

- Authorised firms with goodwill in group/holding companies need to obtain sound financial advice
- With less than 18 months to go, prepare detailed financial plans covering profit and loss, balance sheet and examine whether the capital resources requirement will be met
- If there are likely to be shortfalls then you need to obtain good advice and open up communications with the FSA. The FSA will know from your RMAR (section D1) what the current goodwill add back is. They will not know what your current forecasts are
- Firms should examine their dividend policy, remembering that it should determine the amount of post-tax profits retained by the company rather than how much can be taken out
- Interim net profits can be included in the capital resources but if the firm does not have an audit exemption, any interim profits included must be audited
- If the firm owns land and buildings, which have not been revalued for some time, consider having a professional revaluation carried out. Any revaluation reserve can be included in the capital resources
- Subordinated loans are also eligible and can be created by the completion of an approved form of subordinated loan agreement. This document needs to be approved by the FSA. This can cover amounts owed to directors and/or lenders, which extend beyond two years
- Directors' and other lenders' loans may be reclassified as redeemable preference share capital (where redemption is greater than two years).

Without doubt there is much for brokers to think about between now and January 2008. **IT**

Firms will have to ensure they have enough funds to meet the capital resources requirement come 2008