ACCOUNTING STANDARDS BOARD SEPTEMBER 1994 FRS 6

6

ACQUISITIONS AND MERGERS

ACCOUNTING
STANDARDS
BOARD

FINANCIAL REPORTING
STANDARD

Financial Reporting Standard 6 'Aquisitions and Mergers' is issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Insitute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.

6

ACQUISITIONS AND MERGERS

FINANCIAL REPORTING STANDARD

Financial Reporting Standard 6 is set out in paragraphs 1-39.

The Statement of Standard Accounting Practice set out in paragraphs 4-39 should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2-3 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The Explanation set out in paragraphs 40-89 shall be regarded as part of the Statement of Standard Accounting Practice insofar as it assists in interpreting that statement.

Appendix III 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on FRS 6.

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CONTENTS

SUMMARY

a Financial Reporting Standard 6 'Acquisitions and Mergers' sets out the circumstances in which the two methods of accounting for a business combination—acquisition accounting and merger accounting—are to be used.

b Acquisition accounting regards the business combination as the acquisition of one company by another; the identifiable assets and liabilities of the company acquired are included in the consolidated balance sheet at their fair value at the date of acquisition, and its results included in the profit and loss account from the date of acquisition. The difference between the fair value of the consideration given and the fair values of the net assets of the entity acquired is accounted for as goodwill.

c Merger accounting, on the other hand, treats two or more parties as combining on an equal footing. It is normally applied without any restatement of net assets to fair value, and includes the results of each for the whole of the accounting period. Correspondingly, it does not reflect the issue of shares as an application of resources at fair value. The difference that arises on consolidation does not represent goodwill but is deducted from, or added to, reserves.

d The FRS requires acquisition accounting to be used for any business combination where a party can be identified as having the role of an acquirer, since this method of accounting reflects the application of resources by the acquirer and the net assets acquired.

e Merger accounting is restricted to, and required for, those business combinations where the use of acquisition accounting would not properly reflect the true nature of the combination. A merger is a business combination in which, rather than one party

acquiring control of another, the parties come together to share in the future risks and benefits of the combined entity. It is not the augmentation of one entity by the addition of another, but the creation of what is effectively a new reporting entity from the parties to the combination.

f A combination meets the definition of a merger only if it satisfies the five criteria set out in paragraphs 6 – 11 of the FRS. These criteria relate to:

1 the way the roles of each party to the combination are portrayed;

2 the involvement of each party to the combination in the selection of the management of the combined entity;

3 the relative sizes of the parties to the combination;

4 whether shareholders of the combining entities receive any consideration other than equity shares in the combined entity;

5 whether shareholders of the combining entities retain an interest in the performance of only part of the combined entity.

g Where a combination meets these criteria, acquisition accounting is not permitted as this method would not fairly present the effect of the combination.

h The FRS also contains provisions for applying merger accounting to mergers effected by the creation of a new holding company, and also to certain group reconstructions where acquisition accounting may not be appropriate.

i The FRS contains disclosure requirements applying to business combinations accounted for by using merger accounting so that the transition from separate entities to the merged entity can be understood; and further disclosure requirements, replacing those in SSAP 22 'Accounting for goodwill', for business combinations accounted for by using acquisition accounting, so that the effect of the acquisition can be understood.

FINANCIAL REPORTING STANDARD 6

OBJECTIVE

1 The objective of this FRS is: 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.

DEFINITIONS

2 The following definitions shall apply in this FRS and in particular in the Statement of Standard Accounting Practice set out in paragraphs 4 – 39.

Acquisition :-

A business combination that is not a merger.

Business combination :-

The bringing together of separate entities into one economic entity as a result of one entity uniting with, or obtaining control over the net assets and operations of, another.

Equity shares :-

Shares other than non-equity shares.

Group reconstruction :-

Any of the following arrangements:

(a) the transfer of a shareholding in a subsidiary undertaking from one group company to another;

(b) the addition of a new parent company to a group;

(c) the transfer of shares in one or more subsidiary undertakings of a group to a new company that is not a group company but whose shareholders are the same as those of the group's parent;

(d) the combination into a group of two or more companies that before the combination had the same shareholders.

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 otherwise 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.

Non-equity shares :-

Shares possessing any of the following characteristics:

(a) any of the rights of the shares to receive payments (whether in respect of dividends, in respect of redemption or otherwise) are for a limited amount that is not calculated by reference to the company's assets or profits or the dividends on any class of equity share;

(b) any of their rights to participate in a surplus in a winding up are limited to a specific amount that is not calculated by reference to the company's assets or profits and such limitation had a commercial effect in practice at the time the shares were issued or, if later, at the time the limitation was introduced;

(c) the shares are redeemable, either according to their terms or because the holder, or any party other than the issuer, can require their redemption.

3 References to companies legislation mean:

(a) in Great Britain, the Companies Act 1985;

(b) in Northern Ireland, the Companies (Northern Ireland) Order 1986; and

(c) in the Republic of Ireland, the Companies Acts 1963–90 and the European Communities (Companies: Group Accounts) Regulations 1992.

STATEMENT OF STANDARD ACCOUNTING PRACTICE

The marginal notes give the main references to the Companies Act 1985 in Great Britain. For the equivalent references in companies legislation in Northern Ireland and the Republic of Ireland see Appendix I.

Scope

4 Financial Reporting Standard 6 applies to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. Although the FRS is framed in terms of an entity becoming a subsidiary undertaking of a parent company that prepares consolidated financial statements, it also applies where an individual company or other reporting entity combines with a business other than a subsidiary undertaking.

Use of merger accounting

5 A business combination should be accounted for by using merger accounting if:

(a) the use of merger accounting for the combination is not prohibited by companies legislation; and [4A Sch 10]

(b) the combination meets all the specific criteria set out in paragraphs 6–11 below and thus falls within the definition of a merger.

Acquisition accounting should be used for all other business combinations, except as provided in paragraphs 13 and 14.

Criteria for determining whether the definition of a merger is met

6 *Criterion 1* – No party to the combination is portrayed as either acquirer or acquired, either by its own board or management or by that of another party to the combination.

7 *Criterion 2* – All parties to the combination, as represented by the boards of directors or their appointees, participate in establishing the management structure for the combined entity and in selecting the management personnel, and such decisions are made on the basis of a consensus between the parties to the combination rather than purely by exercise of voting rights.

8 *Criterion 3* – The relative sizes of the combining entities are not so disparate that one party dominates the combined entity by virtue of its relative size.

9 *Criterion 4* – Under the terms of the combination or related arrangements, the consideration received by equity shareholders of each party to the combination, in relation to their equity shareholding, comprises primarily equity shares in the combined entity; and any non-equity consideration, or equity shares carrying substantially reduced voting or distribution rights, represents an immaterial proportion of the fair value of the consideration received by the equity shareholders of that party. Where one of the combining entities has, within the period of two years before the combination, acquired equity shares in another of the combining entities, the consideration for this acquisition should be taken into account in determining whether this criterion has been met.

10 For the purpose of paragraph 9, the consideration should not be taken to include the distribution to shareholders of:

(a) an interest in a peripheral part of the business of the entity in which they were shareholders and which does not form part of the combined entity; or

(b) the proceeds of the sale of such a business, or loan stock representing such proceeds.

A peripheral part of the business is one that can be disposed of without having a material effect on the nature and focus of the entity's operations.

11 *Criterion 5* – No equity shareholders of any of the combining entities retain any material interest in the future performance of only part of the combined entity.

12 For the purposes of paragraphs 6–11 above any convertible share or loan stock should be regarded as equity to the extent that it is converted into equity as a result of the business combination.

Group reconstructions

13 A group reconstruction may be accounted for by using merger accounting, even though there is no business combination meeting the definition of a merger, provided:

(a) the use of merger accounting is not prohibited by companies legislation; *[4A Sch 10]*

(b) the ultimate shareholders remain the same, and the rights of each such shareholder, relative to the others, are unchanged; and

(c) no minority's interest in the net assets of the group is altered by the transfer.

Combination effected by using a new parent company

14 Where a combination is effected by using a newly formed parent company to hold the shares of each of the other parties to a combination, the accounting treatment depends on the substance of the business combination being effected: that is, whether a combination of the entities other than the new parent company would have been an acquisition or a merger. If the combination would have been an acquisition, one entity can be identified as having the role of an acquirer. This acquirer and the new parent company should first be combined by using merger accounting; then the other parties to the business combination should be treated as acquired by this combined company by using the acquisition method of accounting. On the other hand, where the substance of the business combination effected by a new parent company is a merger, the new parent company and the other parties should all be combined by using merger accounting.

Applicability to various structures of business combination

15 The provisions of the FRS, which are explained by reference to an acquirer or issuing entity that issues shares as consideration for the transfer to it of shares in the other parties to the combination, should also be read so as to apply to other arrangements that achieve similar results.

Merger accounting

16 With merger accounting the carrying values of the assets and liabilities of the parties to the combination are not required to be adjusted to fair value on consolidation, although appropriate adjustments *[4A Sch 11]* should be made to achieve uniformity of accounting policies in the combining entities.

17 The results and cash flows of all the combining entities should be brought into the financial statements of the combined entity from the beginning of the financial year in which the combination occurred, adjusted so as to achieve uniformity of accounting policies. The corresponding figures should be restated by including the results for all the combining entities for the previous period and their balance sheets for the previous balance sheet date, adjusted as necessary to achieve uniformity of accounting policies.

18 The difference, if any, between the nominal value of the shares issued plus the fair value of any other consideration given, and the nominal value of the shares received in exchange should be shown as a movement on other reserves in the consolidated financial statements. Any existing balance on the share premium account or capital redemption reserve of the new subsidiary undertaking should be brought in by being shown as a movement on other reserves. These movements should be shown in the reconciliation of movements in shareholders' funds.

19 Merger expenses are not to be included as part of this adjustment, but should be charged to the profit and loss account of the combined entity at the effective date of the merger, as reorganisation or restructuring expenses, in accordance with paragraph 20 of FRS 3 'Reporting Financial Performance'.

Acquisition accounting

20 Business combinations not accounted for by merger accounting should be accounted for by acquisition accounting. Under acquisition accounting, the identifiable assets and liabilities of the companies acquired should be included in the acquirer's *[4A Sch 9]* consolidated balance sheet at their fair value at the date of acquisition. The results and cash flows of the acquired companies should be brought into the group accounts only from the date of acquisition. The figures for the previous period for the reporting entity should not be adjusted. The difference between the fair value of the net identifiable assets acquired and the fair value of the purchase consideration is goodwill, positive or negative.*

Disclosure

Acquisitions and mergers

21 The following information in respect of all business combinations occurring in the financial year, whether accounted for as acquisitions or mergers, should be disclosed in the financial statements of the acquiring entity or, in the case of a merger, the entity issuing shares: *[4A Sch 13(2)]*

(a) the names of the combining entities (other than the reporting entity);

(b) whether the combination has been accounted for as an acquisition or a merger;

(c) the date of the combination.

Mergers

22 In respect of each business combination accounted for as a merger, other than group reconstructions falling within paragraph 13, the following information should be disclosed in the financial statements of the combined entity for the period in which the merger took place:

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* *The date of acquisition and the acquisition of a subsidiary undertaking in stages are dealt with in FRS 2, paragraphs 45, 50, 84-85 and 88-89.*

(a) an analysis of the principal components of the current year's profit and loss account and statement of total recognised gains and losses into *[Extension of 4A Sch 13(4)]*

(i) amounts relating to the merged entity for the period after the date of the merger, and

(ii) for each party to the merger, amounts relating to that party for the period up to the date of the merger.

(b) an analysis between the parties to the merger of the principal components of the profit and loss account and statement of total recognised gains and losses for the previous financial year; *[Extension of 4A Sch 13(4)]*

(c) the composition and fair value of the consideration given by the issuing company and its subsidiary undertakings; *[4A Sch 13(3)]*

(d) the aggregate book value of the net assets of each party to the merger at the date of the merger;

(e) the nature and amount of significant accounting adjustments made to the net assets of any party to the merger to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets of any party to the merger as a consequence of the merger; and *[4A Sch 13(6)]*

(f) a statement of the adjustments to consolidated reserves resulting from the merger. *[4A Sch 13(6)]*

The analysis of the profit and loss account in (a) and (b) above should show as a minimum the turnover, operating profit and exceptional items, split between continuing operations, discontinued operations and acquisitions; profit before taxation; taxation and minority interests; and extraordinary items.

Acquisitions

23 The disclosure requirements for business combinations accounted for as acquisitions apply as follows:

(a) those in paragraphs 24–35 are required for each material acquisition; and, with the exception of those in paragraph 35, should also be given for other acquisitions in aggregate;

(b) the additional disclosure requirements in paragraph 36 apply to substantial acquisitions as defined in paragraph 37.

24 The composition and fair value of the consideration given by the acquiring company and its subsidiary undertakings should be disclosed. The nature of any deferred or contingent purchase consideration should be stated, including, for contingent consideration, the range of possible outcomes and the principal factors that affect the outcome. *[4A Sch 13(3)]*

25 A table should be provided showing, for each class of assets and liabilities of the acquired entity: *[4A Sch 13(5)]*

(a) the book values, as recorded in the acquired entity's books immediately before the acquisition and before any fair value adjustments;

(b) the fair value adjustments, analysed into

(i) revaluations

(ii) adjustments to achieve consistency of accounting policies, and

(iii) any other significant adjustments,

giving the reasons for the adjustments; and

(c) the fair values at the date of acquisition.

The table should include a statement of the amount of purchased goodwill or negative goodwill arising on the acquisition.

26 In the table required by paragraph 25, provisions for reorganisation and restructuring costs that are included in the liabilities of the acquired entity, and related asset write-downs, made in the twelve months up to the date of acquisition should be identified separately.

27 Where the fair values of the identifiable assets or liabilities, or the purchase consideration, can be determined only on a provisional basis at the end of the accounting period in which the acquisition took place, this should be stated and the reasons given. Any subsequent material adjustments to such provisional fair values, with corresponding adjustments to goodwill, should be disclosed and explained.

28 As required by FRS 3, in the period of acquisition the post-acquisition results of the acquired entity should be shown as a component of continuing operations in the profit and loss account, other than those that are also discontinued in the same period; and where an acquisition has a material impact on a major business segment this should be disclosed and explained.

29 Where it is not practicable to determine the post-acquisition results of an operation to the end of the period of acquisition, an indication should be given of the contribution of the acquired entity to the turnover and operating profit of the continuing operations. If an indication of the contribution of an acquired entity to the results of the period cannot be given, this fact and the reason should be explained.

30 Any exceptional profit or loss in periods following the acquisition that is determined using the fair values recognised on acquisition should be disclosed in accordance with the requirements of FRS 3, and identified as relating to the acquisition.

31 The profit and loss account or notes to the financial statements of periods following the acquisition should show the costs incurred in those periods in reorganising, restructuring and integrating the acquisition. Such costs are those that:

(a) would not have been incurred had the acquisition not taken place; and

(b) relate to a project identified and controlled by management as part of a reorganisation or integration programme set up at the time of acquisition or as a direct consequence of an immediate post-acquisition review.

32 Movements on provisions or accruals for costs related to an acquisition should be disclosed and analysed between the amounts used for the specific purpose for which they were created and the amounts released unused.

33 In accordance with FRS 1, the cash flow statement should show the amounts of cash and cash equivalents paid in respect of the consideration, net of any cash and cash equivalents balances transferred as part of the

acquisition. In addition, a note to the cash flow statement should show a summary of the effects of acquisitions indicating how much of the consideration comprised cash and cash equivalents and the amounts of cash and cash equivalents transferred as a result of the acquisition.

34 In accordance with FRS 1, material effects on amounts reported under each of the standard headings reflecting the cash flows of the acquired entity in the period should be disclosed, as far as is practicable, as a note to the cash flow statement. This information need be given only in the financial statements for the period in which the acquisition occurs.

35 For a material acquisition, the profit after taxation and minority interests of the acquired entity should be given for: *[4A Sch 13(4)]*

(a) the period from the beginning of the acquired entity's financial year to the date of acquisition, giving the date on which this period began; and

(b) its previous financial year.

Substantial acquisitions

36 For acquisitions meeting the conditions set out in the next paragraph, the following information should be disclosed in the financial statements of the combined entity for the period in which the acquisition took place: *[Extension of 4A Sch 13(4)]*

(a) the summarised profit and loss account and statement of total recognised gains and losses of the acquired entity for the period from the beginning of its financial year to the effective date of acquisition, giving the date on which this period began; this summarised profit and loss account should show as a minimum the turnover, operating profit and those exceptional items falling within paragraph 20 of FRS 3; profit before taxation; taxation and minority interests; and extraordinary items;

(b) the profit after tax and minority interests for the acquired entity's previous financial year.

This information should be shown on the basis of the acquired entity's accounting policies prior to the acquisition.

37 The disclosures in paragraph 36 should be given for each business combination accounted for by using acquisition accounting where:

(a) for listed companies, the combination is a Class I or Super Class I transaction under the Stock Exchange Listing Rules;

(b) for other entities, either

(i) the net assets or operating profits of the acquired entity exceed 15 per cent of those of the acquiring entity, or

(ii) the fair value of the consideration given exceeds 15 per cent of the net assets of the acquiring entity;

and should also be made in other exceptional cases where an acquisition is of such significance that the disclosure is necessary in order to give a true and fair view. For the purposes of (b) above, net assets and profits should be those shown in the financial statements for the last financial year before the date of the acquisition; and the net assets should be augmented by any purchased goodwill eliminated against reserves as a matter of accounting policy and not charged to the profit and loss account.

Date from which effective

38 The accounting practices set out in the FRS should be regarded as standard in respect of business combinations first accounted for in financial statements relating to accounting periods commencing on or after 23 December 1994. Earlier adoption is encouraged but not required.

Withdrawal of SSAP 23 and amendment of SSAP 22

39 The FRS supersedes SSAP 23 'Accounting for acquisitions and mergers' and paragraphs 48 – 51 of SSAP 22 'Accounting for goodwill'.

EXPLANATION

Introduction

40 Two different methods have been used to account for business combinations: merger accounting and acquisition accounting.

41 In merger accounting the financial statements of the parties to the combination are aggregated, and presented as though the combining entities had always been part of the same reporting entity. Accordingly, although the merger may have taken place part of the way through the financial year, the results of the combining entities for the full financial year are reflected in the group accounts for the period and corresponding amounts are presented on the same basis. The accounting policies of the combining entities are adjusted to achieve uniformity, but the assets and liabilities need not be adjusted to reflect fair values at the date of the combination. Under merger accounting, a difference may arise on consolidation between the nominal value of the shares issued, taken together with the fair value of any other consideration, and the aggregate of the nominal values of the shares received in exchange. Such difference is not goodwill, as it does not result from the difference between the fair value of the consideration and the fair value of the identifiable net assets. It should be shown as a movement on consolidated reserves. Any share premium accounts and capital redemption reserves of the new subsidiary undertaking are not preserved as such in the consolidated accounts, since they do not relate to the share capital of the reporting entity, but are brought in by being shown as a movement on other reserves.

42 In acquisition accounting the results of the acquired company are brought into the group accounts only from the date of acquisition. The identifiable assets

and liabilities acquired are included at fair value in the consolidated accounts and are therefore stated at their cost to the acquiring group. The fair value of the consideration given is set against the aggregate fair value of the net identifiable assets acquired and any resulting balance is goodwill, if positive, or else a negative consolidation difference called negative goodwill.*

43 The fact that a particular business combination does not meet the criteria for merger accounting, and is thus accounted for by using acquisition accounting, does not preclude the acquirer from obtaining merger relief in its individual accounts under the provisions of section 131 of the Companies Act 1985 if the requirements of that section are met. In such cases, in the consolidated accounts, acquisition accounting is applied in the normal way: goodwill is still calculated by comparing the fair value of the shares issued, rather than their nominal or recorded value, with the fair value of the net assets acquired; and any resulting excess over the nominal value of the shares issued, taken together with the fair value of any other consideration, is shown, not as share premium, but as a separate reserve.

Definition of a merger and an acquisition

44 A merger is a rare type of business combination in which two or more parties come together for the mutual sharing of benefits and risks arising from the combined businesses, in what is in substance an equal partnership, each sharing influence in the new entity. No party can be regarded as acquiring control over another, or becoming controlled by another; and the reporting entity formed by the combination must be

* *The treatment of such balances is dealt with in SSAP 22 'Accounting for goodwill' and is the subject of a current ASB project.*

regarded as a new entity rather than the continuation of one of the combining entities, enlarged by its having obtained control over the others.

45 An acquisition is defined as any business combination that is not a merger. In many acquisitions, the shareholders of the acquired party do not have a continuing interest in the combined entity, but instead sell their shareholdings for cash or other non-equity consideration. Even where all parties in an acquisition retain an interest in the combined entity, the parties do not come together on equal terms; one party has a greater degree of influence than the others, and is seen as acquiring the other entities in exchange for a share in the combined entity. An acquisition is therefore a transaction that is, in substance, the application of resources by the acquiring entity to obtain control of one or more other entities, by the payment of cash, transfer of other assets, the incurring of a liability or the issue of shares.

46 The legal form of a business combination will normally be for one company to acquire shares in one or more others. This fact does not make that company an acquirer in the sense discussed above. Similarly, the question of whether the combined entity should be regarded as a new reporting entity is not affected by whether or not a new legal entity has been formed to acquire shares in others.

Rationale for merger accounting

47 In a merger, no party to the combination can be properly regarded as obtaining control over the other; rather, the parties to the combination join together on an equal footing to form a combined enterprise for their mutual benefit.

48 For such mergers it is misleading to account for the combination as the application of resources by one party to obtain control over the other, since this assumes a distinction in the roles of the parties that does not reflect reality. Furthermore, it is only the legal structure of the combination that would determine which party would be treated under acquisition accounting as the acquirer, and thus determine the party whose net assets would be treated as being acquired and whose goodwill would be recognised.

49 A merger is a true mutual sharing of the benefits and risks of the combined entity. Therefore the joint history of the entities that have combined will be relevant to the combined group's shareholders. This record will be provided by merger accounting because it treats the separate businesses as though they were continuing as before, only now jointly owned and managed. If acquisition accounting were to be used, it would focus artificially on only one of the parties to the combination, which would lead to a discontinuity in information reported on the combined entity.

50 Thus the concept of a merger is of a partnership or pooling of interests, where all the parties to the combination participate in the combined businesses of the merged entity on substantially equal terms; and where the substance of the arrangement is such that the reporting entity cannot be regarded as merely being enlarged by the acquisition of the other entities, but must be considered as effectively a new reporting entity.

51 In a business combination that qualifies as a merger, expenses of the combination are similar in nature to expenses of a fundamental reorganisation or restructuring, and should be charged to the profit and loss account for the period in which the merger

occurred, shown as an exceptional item in accordance with paragraph 20 of FRS 3. This is not intended to prohibit the subsequent charging of issue costs to the share premium account by means of a transfer between reserves.

Rationale for acquisition accounting

52 The acquisition of another entity is a transaction by which an entity seeks to increase the assets under its control. Acquisition accounting is appropriate for most business combinations since it reflects in the financial statements the application of resources by one party to the combination in order to obtain control of the other, represented by the fair value of the net assets over which control is obtained together with goodwill.

53 The profits of the acquired company are brought into account only from the date of the combination and the history of the group is seen as the history of the acquirer with occasional additions when it acquires other entities.

Deciding whether a business combination is a merger or an acquisition

54 The FRS requires that to determine whether a business combination meets the definition of a merger, it should be assessed against certain specified criteria; failure to meet any of these criteria indicates that the definition was not met and thus that merger accounting is not to be used for the combination.

55 Individually these tests are insufficient to define the intangible quality of a true merger, and may appear arbitrary. Nevertheless, taken as a whole, they provide a reasonable basis for determining whether a particular business combination meets the definition of a merger and thus should be accounted for by using merger accounting.

56 In applying the criteria, it is necessary to consider the substance and not just the form of the arrangements, and to take account of all relevant information related to the combination. It is important to have regard to the transaction as a whole, including any related arrangements that are connected with the business combination either because they are entered into in contemplation of that combination or because they are part of the process by which that combination is effected. The vast majority of business combinations will be acquisitions and only in rare circumstances will a combination fulfil all the detailed conditions for it to be treated as a merger.

Parties to the combination

57 For the purposes of assessing whether a combination is a merger meeting the criteria, the parties to the combination are considered as comprising not solely the business of each entity that is combining but also the management of the entity and the body of its shareholders.

58 Merger accounting is not appropriate for a combination where one of the parties results from a recent divestment by a larger entity, because the divested business will not have been independent for a sufficient period to establish itself as being a party separate from its previous owner. Only once the divested business has established a track record of its own can it be considered as a party to a merger. However, a party to a combination may divest itself of a peripheral part of its business before the combination (or as part of the arrangements for the combination) and still meet the criteria for merger accounting.

59 Where a party to the combination is not a company with share capital, the conditions applying to equity shares should be interpreted as applying to those elements of its capital structure that allocate rights to profits and control.

Criterion 1 – role of the parties

60 An essential feature of a merger is that it represents a genuine combining of the interests of the parties; such a genuine combination of interests cannot exist if one party portrays itself, or another party, as having a dominant role as an acquirer or the subservient role of being acquired.

61 Where the terms of a share-for-share exchange indicate that one party has paid a premium over the market value of the shares acquired, this is evidence that that party has taken the role of an acquirer unless there is a clear explanation for this apparent premium other than its being a premium paid to acquire control.

62 The circumstances surrounding the transaction may provide evidence to indicate the nature of a business combination. The following, while not individually conclusive, would need to be considered: the form by which the combination was achieved, the plans for the combined entity's future operations (for example, whether any closures or disposals related more to one party than another), and the proposed corporate image (such as the name, logo and the location of the headquarters and principal operations). Where a publicly quoted company is a party to a business combination, the content of communications with its shareholders is likely also to be relevant in determining the substance of the transaction.

Criterion 2 – dominance of management

63 An essential feature of the genuine combination of interests underlying the definition of a merger is that all parties to the combination are involved in determining the management of the combined entity and reach a consensus on the appropriate structure and personnel; if decisions can be reached only by the

exercise of majority voting rights against the wishes of one of the parties to the merger, or if one party clearly dominates this process, this indicates that the combination is not a genuine pooling of interests. However, this does not preclude the possibility of all, or most, of the management team of the combined entity coming from only one of the parties, provided that this clearly reflects the wishes of the others.

64 In applying this test, it is necessary to consider not only the formal management structure of the combined entity, but also the identity of all persons involved in the main financial and operating decisions and the way in which the decision-making process operates in practice within the combined entity.

65 Normally the management of the combined entity would contain representatives of each of the combining parties. Where the senior management structure and personnel of the combined entity are essentially those of one of the combining parties, this criterion will not have been met unless it is clear that all the parties to the merger genuinely participated in the decision.

66 In applying this test it is necessary to consider only the decisions made in the period of initial integration and restructuring at the time of the combination; but both the short-term effects and expected long-term consequences of decisions made in this period need to be considered.

Criterion 3 – relative size of the parties

67 Where one party is substantially larger than the other parties it would be presumed that the larger party can or will dominate the combined undertaking. This will not be consistent with treating such a business combination as a merger as the combined entity will not be a substantially equal partnership.

68 A party would be presumed to dominate if it is more than 50 per cent larger than each of the other parties to the combination, judged by reference to the ownership interests; that is, by considering the proportion of the equity of the combined entity attributable to the shareholders of each of the combining parties. However, this presumption may be rebutted if it can be clearly shown that there is no such dominance; other factors, such as voting or share agreements, blocking powers or other arrangements, can mean that a party to the combination has more influence, or conversely less influence, than is indicated by its relative size. Circumstances that rebut the presumption of dominant influence based on relative sizes would need to be disclosed and explained.

Criterion 4 – non-equity consideration

69 Criterion 4 is concerned with the extent to which equity shareholders of the combining entities receive any consideration other than equity shares (as defined in paragraph 2 above) in the combined entity. Cash, other assets, loan stock and preference shares are all examples of non-equity consideration.

70 As stated in the note on legal requirements (Appendix I), companies legislation provides that one of the conditions for merger accounting is that the fair value of any consideration other than the issue of equity shares (as defined in companies legislation) did not exceed 10 per cent of the nominal value of the equity shares issued. Criterion 4 requires a further condition to be met, that all but an immaterial proportion of the fair value of the consideration received must be in the form of equity shares (as defined in paragraph 2); this definition of equity, which is that adopted in FRS 4 'Capital Instruments', is narrower than that of companies legislation, and is used to avoid the possibility of criterion 4 being met by the use of shares that, although within the statutory definition of equity, have characteristics that are closer to non-equity.

71 The FRS requires that all arrangements made in conjunction with the combination must be taken into account. Equity shareholders will be considered to have disposed of their shareholding for cash where any arrangement is made in connection with the combination that enabled them to exchange or redeem the shares they received in the combination for cash (or other non-equity consideration); for example, a vendor placing or similar arrangement should be treated as giving rise to non-equity consideration. However, a normal market selling transaction, or privately arranged sale, entered into by a shareholder is not made in conjunction with the combination and does not prevent the criterion being met.

72 A business combination may not be accounted for as a merger if a material part of the consideration that the issuing entity offers the equity shareholders in the other parties is in the form of shares with substantially reduced rights. Such an offer would be contrary to the concept that a merger is the mutual sharing in risks and rewards of the combined entity. Some adjustment to the rights attaching to the shares held by the non-issuing entities' shareholders may be compatible with the combination being a merger, as business combinations result from a negotiating process where different pre-existing rights have to be reconciled. Whether any change in the rights of one group of shareholders is sufficient to prevent that business combination being treated as a merger will depend on the facts in any individual case, taking into account such matters as what rights shareholders originally had, the total arrangement negotiated, time limits and whether any new restrictions apply equally to all sets of shareholders. In determining whether equity shares with reduced rights have been issued, both rights to vote and rights to distributions attaching to the shares would need to be taken into account. If any of these individual rights were significantly reduced or circumscribed the combination would fail to fulfil this condition.

73 If one entity has acquired an interest in another in exchange for non-equity consideration, or equity shares with significantly reduced rights, within the two years before those entities combined, such consideration should be regarded as part of the consideration for the combination for the purpose of determining whether this criterion is met.

74 Sometimes a peripheral part of the business of one of the combining parties will be excluded from the combined entity. The FRS states that shares in the peripheral business, or the proceeds of sale of the business, that are distributed to the shareholders of that party to the combination as part of the arrangements for the combination are not to be counted as part of the consideration for the purposes of this criterion.

Criterion 5 – minorities etc

75 Criterion 5 is concerned with a party retaining an interest in only part of the combined entity. The concept of a merger is that the participants enter into a mutual sharing of the risks and rewards of the whole of the new entity, including the pooled future results of the combined entity. This concept is incompatible with certain participants having a preferential interest in one part of the combined entity. This criterion would not, therefore, be met if the share of the equity in the combined entity allocated to the shareholders of one of the parties to the combination depended to any material extent on the post-combination performance of the business, or any part of it, formerly controlled by that party.

76 This criterion would similarly not be met where earn-outs or similar performance-related schemes are included in the arrangements to effect a merger. The test is also failed if there is any material minority (defined by companies legislation as 10 per cent) of shareholders left in one of the combining parties that have not accepted the terms of the combination offer.

77 However, the criterion would not necessarily be invalidated by an arrangement whereby the allocation of consideration between the shareholders of the combining parties depended on the determination of the eventual value of a specific liability or asset contributed by one of the parties—such as the eventual outcome of a claim against one of the parties, or the eventual sales value of a specific asset owned by one of the parties—as opposed to the future operating performance of that party.

Group reconstructions

78 In addition to mergers as defined above, merger accounting may also be appropriate for a group reconstruction, provided that the relative rights of the ultimate shareholders are not altered. Such reconstructions include not only the transfer of shares in a subsidiary undertaking within a group, but also arrangements such as the introduction of a new holding company, the splitting off of one or more subsidiary undertakings, as in some demergers, where a separate group is formed, and the bringing together into a new group of two or more companies that were previously under common ownership. Acquisition accounting would require the restatement at fair value of the assets and liabilities of the company transferred, and the recognising of goodwill, which is likely to be inappropriate in the case of a transaction that does not alter the relative rights of the ultimate shareholders.

79 Where a minority interest exists, merger accounting is permitted only for those group reconstructions that do not change the interest of the minority in the net assets of the group. Thus the transfer of a subsidiary undertaking within a subgroup that has a minority shareholder may qualify for merger accounting; but acquisition accounting must be used for the transfer of a subsidiary undertaking out of, or into, such a

subgroup. If a minority has effectively acquired, or disposed of, rights to part of the net assets of the group, the FRS requires the transfer to be accounted for by using acquisition accounting rather than merger accounting.

Disclosure

80 The disclosure requirements in the FRS cover and supplement those in companies legislation.

Mergers

81 With merger accounting the financial statements of the combined entity are drawn up by combining the results of the combining entities for the whole of the financial year in which the merger occurred. Users, particularly those who have been assessing the parties to the combination as separate businesses, may require information on the financial performance of the individual parties. The FRS therefore requires an analysis of the profit and loss account and statement of total recognised gains and losses into pre- and post-merger amounts; and a further analysis of the pre-merger amounts between each of the parties to the merger. An analysis between the parties of the preceding financial year is also required. However, it is not necessary, where revaluation gains or losses have been recognised as a result of a valuation at the year-end, to obtain further valuations at the date of the merger in order to apportion the gains or losses between pre- and post-merger periods.

82 Group reconstructions that are accounted for by using merger accounting are exempted from the disclosure requirements in the FRS, but must still give the information required by companies legislation.

Acquisitions

83 The disclosure requirements of the FRS provide information about the resources applied in acquisitions, the net assets acquired and the effects on the consolidated financial statements of the acquiring group. Separate presentation of the results of acquisitions assists analysis of the significance of new operations that have been acquired. In some circumstances it may also be useful to users for the results of acquisitions for the first full financial year for which they are a part of the reporting entity to be disclosed in the notes.

84 Paragraph 23 of the FRS requires the disclosures in paragraphs 24–35 to be given for each material acquisition, and those in paragraphs 24–34 to be given for other acquisitions in aggregate. Materiality must be judged by whether the information relating to the acquisition might reasonably be expected to influence decisions made by the users of general purpose financial statements. Paragraph 36 applies further disclosure requirements to certain substantial acquisitions.

85 In order to give a true and fair view of post-acquisition financial performance, paragraph 30 of the FRS requires disclosure of exceptional profits or losses determined using fair values recognised on an acquisition. Examples include profits or losses on the disposal of acquired stocks where the fair values of stocks sold lead to abnormal trading margins after the acquisition; the release of provisions in respect of an acquired loss-making long-term contract that the acquirer makes profitable; and the realisation of contingent assets or liabilities at amounts materially different from their attributed fair values. In accordance with the requirements of FRS 3, exceptional items would be included in the profit and loss account format headings to which they relate, and

would be disclosed by way of note, or on the face of the profit and loss account if necessary to give a true and fair view.

86 FRS 3 requires the profits or losses on the post-acquisition sale or termination of an operation, or on the disposal of fixed assets, to be shown in the profit and loss account below operating profit. Post-acquisition integration, reorganisation and restructuring costs, including provisions in respect of them, would, if material, be reported as exceptional items; but only if the restructuring is fundamental, having a material effect on the nature and focus of the enlarged group's operations, would the costs be shown below operating profit as an item falling under paragraph 20 of FRS 3. Paragraph 31 of FRS 6 requires that costs of reorganising, restructuring and integration that relate to an acquisition, whether relating to a fundamental restructuring or not, should be shown separately from other exceptional items.

87 The costs of reorganising, restructuring and integrating an acquired entity may extend over more than one period. For major acquisitions, therefore, management may wish to state in the notes to the financial statements the nature and amount of such costs expected to be incurred in relation to the acquisition (including asset write-downs), indicating the extent to which they have been charged to the profit and loss account. If part of these costs relate to asset write-downs (beyond any impairments recognised in adjusting to fair values on the acquisition) it may be useful to distinguish these from cash expenditure. An illustrative example of how such information might be shown is included as Appendix IV to the FRS.

Substantial acquisitions

88 Where an acquisition has been made that has a substantial effect on the consolidated results of the acquiring entity, additional disclosures are required to enable the user to assess the effect of the acquisition on the consolidated results. Although control over the acquired entity is obtained only at the date of acquisition, in most cases it is a continuing business that is acquired, and information on the results for the period up to the date of acquisition is relevant to the user. For acquisitions that meet the size tests in paragraph 37, the FRS therefore requires the disclosure of the results of the acquired entity for the part of its financial year up to the date of the acquisition, and for its previous financial year. Since neither of these periods will necessarily be twelve months, their commencing dates should also be indicated.

89 Several components of the pre-acquisition results are required to be shown for the part of the acquired entity's financial year up to the date of acquisition, since this period may be particularly relevant to an understanding of the post-acquisition results and may not otherwise be publicly reported. Equivalent information for the preceding financial year is likely to be of less relevance, and the disclosure requirement is limited to profit after tax and minority interests. The FRS requires this information to be given on the basis of the acquired entity's accounting policies before the acquisition; in some cases, the management of the acquiring entity may consider it helpful in explaining the impact of the acquisition to give, in addition, the same information restated onto the basis of the acquiring entity's accounting policies.

ADOPTION OF FRS 6 BY THE BOARD

Financial Reporting Standard 6 – 'Acquisitions and Mergers' was approved for issue by the eight members of the Accounting Standards Board.

Sir David Tweedie	(Chairman)
Allan Cook	(Technical Director)
Robert Bradfield	
Ian Brindle	
Michael Garner	
Raymond Hinton	
Donald Main	
Graham Stacy	

APPENDIX I

NOTE ON LEGAL REQUIREMENTS

Great Britain

References are to the Companies Act 1985

Merger accounting

1 The Companies Act describes the acquisition method of accounting (Schedule 4A paragraph 9) and the merger method of accounting (Schedule 4A paragraph 11). Schedule 4A paragraph 10 lays down the conditions that must be met if a business combination is to be accounted for as a merger. The conditions are:

(a) that at least 90 per cent of the nominal value of the relevant shares (those with unrestricted rights to participate both in distributions and in the assets on liquidation) in the undertaking acquired is held by or on behalf of the parent company and its subsidiary undertakings;

(b) that the proportion referred to in (a) 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;

(c) that 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; and

(d) that adoption of the merger method of accounting accords with generally accepted accounting principles or practice.

2 Where a group is acquired, the Companies Act requirements described in the previous paragraph also apply. References to shares of the undertaking acquired are to be construed as references to the shares of the acquired group's parent and references to the assets and liabilities, income and expenditure, and capital and reserves of the undertaking acquired are to be construed as references to the same elements of the group acquired, after making the necessary set-off and adjustments required for the consolidated accounts (Schedule 4A paragraph 12).

Disclosures

3 The following information shall be given in a note to the accounts for all business combinations taking place in the financial year:

(a) the names of the entities involved;

(b) whether the combination has been accounted for by the acquisition or merger method of accounting (Schedule 4A paragraph 13(2)).

4 In addition, for any business combination that significantly affects the figures shown in the group accounts, the following further information shall be given:

(a) the composition and fair value of the consideration for the acquisition given by the parent and its subsidiary undertakings (Schedule 4A paragraph 13(3));

(b) the profit or loss of the undertaking or group acquired for the period up to the date of the acquisition from the beginning of the financial year of that undertaking or group, and for the previous financial year of that undertaking or group. The date on which this financial year began should also be stated (Schedule 4A paragraph 13(4)).

5 Where the acquisition method of accounting has been adopted, the book values immediately prior to acquisition and fair values at the date of acquisition of each class of assets and liabilities of the acquired entity shall be stated in tabular form, including a statement of the amount of any goodwill or negative consolidation difference arising on the acquisition, together with an explanation of any significant adjustments made (Schedule 4A paragraph 13(5)).

6 Where the merger method of accounting has been adopted, an explanation shall be given of any significant adjustments made in relation to the amounts of the assets and liabilities of the undertaking or group acquired, together with a statement of any resulting adjustment to the consolidated reserves (including the restatement of opening consolidated reserves) (Schedule 4A paragraph 13(6)).

7 None of the information required by paragraph 13 of Schedule 4A to the Act need be disclosed for an undertaking which:

(a) is established under the law of a country outside the United Kingdom; or

(b) carries on business outside the United Kingdom

if, in the opinion of the directors of the parent company, the disclosure would be seriously prejudicial to the business of that undertaking or to the business of the parent company or any of its subsidiary undertakings and the Secretary of State agrees that the information should not be disclosed (Schedule 4A paragraph 16).

Share premium and merger relief

8 Section 130(1) of the Companies Act provides that if a company issues shares at a premium, whether for cash

or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares should be transferred to an account called the share premium account. The provisions of the Companies Act relating to the reduction of a company's share capital apply, with exceptions, as if the share premium account were part of its paid-up share capital.

9 Limited relief from the above ('merger relief') is given by sections 131–134.

10 Section 131 of the Companies Act provides, inter alia, that, subject to specified conditions, where an issuing company has secured at least a 90 per cent equity holding in another company, section 130 does not apply to the premium on shares issued in the transaction which takes the holding in that other company to at least 90 per cent.

11 Section 133(1) provides that the premium on any shares to which the relief in sections 131 and 132 of the Companies Act applies may also be disregarded in determining the amount at which any shares, or other consideration provided for the shares issued, are to be included in the offeror company's balance sheet.

12 The Companies Act requires the disclosure of additional information where merger relief is taken. Schedule 5 paragraphs 10 and 29 refer respectively to companies that are not obliged to prepare group accounts and those that are. They apply to arrangements attracting merger relief, that is, where a company allots shares in consideration for the issue, transfer or cancellation of shares in another body corporate ('the other company') in circumstances such that section 131(2) (merger relief) applies to the premiums on the shares.

13 If the company makes such an arrangement during the financial year, the following information shall be given:

(a) the name of the other company;

(b) the number, nominal value and class of shares allotted;

(c) the number, nominal value and class of shares in the other company issued, transferred or cancelled; and

(d) particulars of the accounting treatment adopted in the consolidated accounts in respect of the issue, transfer or cancellation.

14 In addition, for companies that are required to prepare group accounts Schedule 5 paragraph 29(2) requires the disclosure of particulars of the extent to which and manner in which the profit or loss for the financial year shown in the consolidated accounts is affected by any profit or loss of the other company, or any of its subsidiary undertakings, that arose before the time of the arrangement.

Accounts of the parent company

15 The FRS deals only with the method of accounting to be used in group accounts; it does not deal with the form of accounting to be used in the acquiring or issuing company's own accounts and in particular does not restrict the reliefs available under sections 131–133 of the Companies Act.

16 Where a dividend is paid to the acquiring or issuing company out of pre-combination profits, it would appear that it need not necessarily be applied as a reduction in the carrying value of the investment in the subsidiary undertaking. Such a dividend received should be applied to reduce the carrying value of the investment to the extent necessary to provide for a diminution in value of the investment in the subsidiary undertaking as stated in the accounts of the parent company. To the extent that this is not necessary, it appears that the amount received will be a realised profit in the hands of the parent company.

Northern Ireland

17 The legal requirements in Northern Ireland are similar to those in Great Britain. The following table shows the references to the Companies (Northern Ireland) Order 1986 that correspond to the marginal references in the FRS and the legal references in paragraphs 1–16 above.

Great Britain: the Companies Act 1985	***Northern Ireland: the 1986 Order***
Merger accounting	
Schedule 4A paragraphs 9–12	Schedule 4A paragraphs 9–12
Disclosures	
Schedule 4A paragraph 13	Schedule 4A paragraph 13
Schedule 4A paragraph 16	Schedule 4A paragraph 16
Share premium and merger relief	
Sections 130–134	Articles 140–144
Schedule 5 paragraph 10	Schedule 5 paragraph 10
Schedule 5 paragraph 29	Schedule 5 paragraph 29

Republic of Ireland

18 The following table shows the references to the European Communities (Companies: Group Accounts) Regulations 1992 and the Companies Act 1963 that correspond to the marginal references in the FRS and the legal references in paragraphs 1 – 16 above.

Great Britain: the Companies Act 1985	***Republic of Ireland: the 1992 Regulations***
Merger accounting	
Schedule 4A paragraph 9	Paragraph 19
Schedule 4A paragraph 10	Paragraph 21
Schedule 4A paragraph 11	Paragraph 22
Schedule 4A paragraph 12	Paragraph 23
Disclosures	
Schedule 4A paragraph 13(2)	The Schedule paragraph 12(2)
Schedule 4A paragraph 13(3)–13(6)	No exact equivalent; paragraph 27 of the 1992 Regulations states that if the composition of the undertakings dealt with in the group accounts has changed significantly in the course of a financial year, the group accounts must include information that makes the comparison of successive sets of group accounts meaningful.
Schedule 4A paragraph 16	No equivalent

Share premium and merger relief

Section 130	Companies Act 1963 section 62
Sections 131–134	No equivalent
Schedule 5 paragraph 10	No equivalent
Schedule 5 paragraph 29	No equivalent

Merger relief in the Republic of Ireland

19 As there is currently no legislation equivalent to merger relief in the Republic of Ireland, no explicit relief from the requirement of section 62(1) of the Companies Act 1963 to establish a share premium account is available.

20 However, section 149(5) of the Companies Act 1963 provides that, whilst, in general, pre-acquisition profits of acquired subsidiaries may not be treated in the holding company's accounts as revenue profit, an exemption from that provision is available in that, where the directors and auditors are satisfied and so certify that it would be fair and reasonable and would not prejudice the rights and interests of any person, the profits or losses attributable to any shares in a subsidiary may be treated in a manner otherwise than in accordance with that subsection.

21 The possible need for legal advice in relation to the application of section 149(5) to merger accounting should be considered before merger accounting is applied to Republic of Ireland companies.

APPENDIX II

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

The requirements of the FRS are consistent with International Accounting Standard 22 'Business Combinations' (revised 1993), except for the provision in paragraph 13 of that standard relating to reverse acquisitions, which is incompatible with companies legislation in the UK and the Republic of Ireland.

APPENDIX III

THE DEVELOPMENT OF THE FRS

History

Before the Companies Act 1981

1 Although some use was made of merger accounting in the UK before the Companies Act 1981, and indeed an exposure draft of an accounting standard, ED 3, was published (in 1971), there was concern that the share premium provisions of the Companies Act 1948 might be interpreted so as to prohibit the use of merger accounting. This view was confirmed by the decision in *Shearer v Bercain* in 1980.

The Companies Act 1981 and SSAP 23

2 The Companies Act 1981 introduced the concept of merger relief, removing the legal obstacle to merger accounting. Following this, the Accounting Standards Committee (ASC) issued an exposure draft, ED 31, converted into an accounting standard, SSAP 23 'Accounting for acquisitions and mergers', in 1985.

3 SSAP 23 based its concept of a merger on whether or not the arrangements for the combination resulted in material resources leaving the group. This concept was supported by four criteria defining the circumstances in which merger accounting was permitted:

(a) the business combination results from an offer to the holders of all equity shares and the holders of all voting shares that are not already held by the offeror; and

(b) the offeror has secured, as a result of the offer, a holding of (i) at least 90 per cent of all equity shares (taking each class of equity separately) and (ii) the shares carrying at least 90 per cent of the votes of the offeree; and

(c) immediately prior to the offer, the offeror does not hold (i) 20 per cent or more of all equity shares of the offeree (taking each class of equity separately) or (ii) shares carrying 20 per cent or more of the votes of the offeree; and

(d) not less than 90 per cent of the fair value of the total consideration given for the equity share capital (including that given for shares already held) is in the form of equity share capital; not less than 90 per cent of the fair value of the total consideration given for voting non-equity share capital (including that given for shares already held) is in the form of equity and/or voting non-equity share capital.

4 Note, however, that merger accounting remained optional even if these criteria were met.

The EC Seventh Directive and the Companies Act 1989

5 The EC Seventh Company Law Directive introduced more stringent requirements to be met before merger accounting was permitted. The conditions of the Directive were implemented in Great Britain, with some additional provisions, by the Companies Act 1989, as amendments to the Companies Act 1985. These conditions are:

(a) that at least 90 per cent of the nominal value of the relevant shares (those with unrestricted rights to participate both in distributions and in the assets on liquidation) in the undertaking acquired is held by or on behalf of the parent company and its subsidiary undertakings;

(b) that the proportion referred to in (a) 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;

(c) that 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; and

(d) that adoption of the merger method of accounting accords with generally accepted accounting principles or practice.

6 In requiring compliance with generally accepted accounting principles, the Companies Act clearly acknowledged that merger accounting would not be appropriate for all business combinations that met the first three conditions.

7 The comparison, in condition (c), with the nominal value of shares issued is also noteworthy. The nominal value is of no economic significance. In contrast, the corresponding condition (d) of SSAP 23 refers to the fair value of the equity shares issued.

Limiting the use of merger accounting—the ED 48 proposals

8 ED 48 was issued by the ASC in February 1990 in response to widespread concern that the SSAP 23 conditions were too readily circumvented. It proposed to limit the use of merger accounting to a very restricted class of combinations that could be regarded as 'true' mergers. These were to be defined as a combination that was effectively an equal partnership between the combining parties, where no party saw itself as either an acquirer or an acquiree. In addition,

there had to be continuing involvement from the management of each of the parties in the combined entity; and the parties were to be of broadly equal size. Any minority not accepting the merger offer was not to exceed 10 per cent, and no material consideration other than equity shares was permitted.

9 ED 48 then proposed that merger accounting would be required, and not merely permitted, for all combinations meeting these conditions (although, as a practical matter, it has been suggested that it would be relatively easy for merging parties to ensure that one of the conditions was not met, without fundamentally altering the commercial substance of the transaction, if they did not wish to use merger accounting—and thus for practical purposes the option to use acquisition accounting might be seen to remain).

10 Although respondents to ED 48 were generally in agreement with its proposals, there was criticism of the conditions for merger accounting, in particular of their subjective nature, which, it was expected, would give rise to difficulties in applying them consistently.

International Accounting Standards

11 The merger concept underlying ED 48 is similar to that proposed for a 'uniting of interests' in the International Accounting Standard 22, revised in 1993, although that standard does not develop tests for identifying when a combination is a merger. IAS 22 defines a uniting of interests as:

> "a business combination in which the shareholders of the combining enterprises combine control over the whole, or effectively the whole, of their net assets and operations to achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer."

FRED 6

12 In considering the application of merger accounting, the Board was concerned by the apparent choice available in many cases between acquisition and merger accounting, and that two business combinations with very similar economic substance could be accounted for in different ways, with substantial differences in reported results and balance sheets not only for the financial year in which the combination occurred but for several years thereafter. The Board also found it difficult to identify any theoretical basis to justify the use of merger accounting for the wide range of business combinations for which it was then permissible.

13 In issuing FRED 6, the Board therefore adopted the intention of ED 48, of narrowing the use of merger accounting.

14 No major changes were proposed, but the Board sought to remove subjectivity where possible. The approach of the FRED was based on the belief that merger accounting should be applied to only a few rare instances of business combinations that were properly regarded as mergers, and that the vast majority of business combinations were more appropriately accounted for as acquisitions.

15 The definition of a merger was redrafted, but its intent was unchanged. The definition of an acquisition was amended to make it clear that all combinations were either mergers or acquisitions.

16 The six conditions under which merger accounting would have been permitted by ED 48 were redrafted as five criteria, as follows:

Criterion 1 – redrafted form of ED 48 condition (a).

Criterion 2 – amended form of ED 48 condition (b), acknowledging that to require the board of a merged entity to have equal participation from each of the parties to the merger might prevent the parties to the merger from choosing the management they considered most appropriate; and might lead to too much focus on the numerical representation of each party on the new board at the expense of considering where the real decision taking influence lay.

Criterion 3 – redrafted form of ED 48 condition (e).

Criterion 4 – redrafted form of ED 48 condition (c).

Criterion 5 – redrafted form of ED 48 conditions (d) and (f), reducing these to a more general principle.

Disclosure

17 The disclosure requirements proposed by ED 48 were extended to require analysis into pre-combination and post-combination periods of several items in the profit and loss account, and the statement of total recognised gains and losses, rather than focusing solely on profit after tax and extraordinary items.

Matters considered in the light of responses to FRED 6

18 A large majority of the respondents to FRED 6 agreed with the proposals it contained, and these are accordingly unchanged. The following paragraphs describe those points on which respondents expressed concern and explain whether or not a change was made and the Board's reasoning for its decision.

Disclosure requirements on an acquisition

19 The full disclosure requirements proposed in the FRED relating to the pre-combination results of the parties to a merger, and the acquired entity in an acquisition, were supported by a majority of respondents, and particularly by users of accounts. Concern was expressed, however, at the practical difficulties in obtaining this information relating to acquisitions, and many preparers of financial statements questioned whether such disclosures were, in practice, of value to users.

20 The Board has therefore reconsidered the extent of the disclosures required in respect of the acquired company, and has made three main relaxations in the requirements:

(a) less detailed analysis of the results of the acquired company up to the date of acquisition is now required;

(b) only the profit after tax and minority interests for its previous financial year is now required to be shown; and

(c) fuller disclosure is now required only for substantial acquisitions, defined as being 'Class I' or 'Super Class I' where the acquirer is a listed company, or in excess of 15 per cent of net assets or profits for others.

The FRS now states that this information is to be given using the accounting policies of the acquired company, instead of being restated using the acquirer's accounting policies.

21 Some respondents suggested that it would be more helpful for all disclosure requirements relating to acquisitions to be consolidated into one standard. The Board has accordingly included in this FRS the proposed disclosure requirements set out in FRED 7 (which were based on those in SSAP 22), amended to take account of responses made to that FRED. It has also incorporated references to the disclosure requirements relating to acquisitions in FRS 1 and FRS 3, unchanged other than to make it clear that the disclosures should be made separately for each material acquisition, and for other acquisitions in aggregate.

Disclosure requirements on a merger

22 The Board concluded that, in the case of a merger, no relaxation of the proposed disclosures was appropriate. Because of the continuing involvement of management of both parties to the merger, the practical difficulties would be less, and the likely significance of the merger to the shareholders would make it desirable to provide fuller information. Although it was argued that analysing pre-merger results among the parties was in some sense contrary to the concept of merger accounting, in that the financial statements were drawn up on the basis that the parties had always been merged, the Board took the view that full information on the combining parties separately was important to an understanding of the combined entity.

Definitions and criteria for merger accounting

23 The definitions of mergers and acquisitions, and the criteria for merger accounting, were generally agreed as appropriate by respondents, and only minor drafting changes have been made. Criterion 4 has been amended to make clear the effect of an entity disposing of part of its business prior to the combination.

Group reconstructions

24 There was general agreement with the proposed use of merger accounting in group reconstructions, but some respondents requested that this should be more widely available. The Board has therefore agreed to widen the definition of group reconstructions, provided minority rights are unaffected, to include situations where a new holding company is created; where a 'horizontal group' of companies under common ownership become a group under the companies legislation definition; and where a part of a group is transferred to a new company, not part of the group but owned by the same shareholders as the group.

Merger expenses

25 The FRED proposed that merger expenses should be charged to the profit and loss account. Although a majority of respondents supported this proposal, there was significant support for deducting such costs from reserves, in a way similar to the costs of issuing an equity instrument under FRS 4. The Board believes, however, that there is a fundamental difference between the costs of issue of an equity instrument, which raises new capital, from which the costs may sensibly be deducted, and the costs of a merger, which does not raise new capital, but which requires an expenditure of resources that should therefore be charged to the profit and loss account. The Board has clarified that these costs should be shown as an exceptional item in accordance with paragraph 20 of FRS 3.

Demergers

26 Several respondents suggested that the FRS should deal with the accounting issues arising on demergers as well. However, the Board took the view that such issues as arise on a demerger are unrelated to those of business combinations, and should not be dealt with in the same FRS (although the restructuring that takes place on a demerger may fall within the group restructuring provisions of this FRS).

Alternative view – prohibiting the use of merger accounting

27 The Preface to the FRED set out an alternative view, that the use of merger accounting should be prohibited (other than for certain group reconstructions). This alternative view attracted little support; most commentators thought that mergers, although rare, were a separate class of business combination for which merger accounting should be available. The Board has, accordingly, not proceeded with that proposal.

APPENDIX IV

ILLUSTRATIVE EXAMPLE OF DISCLOSURE OF REORGANISATION AND INTEGRATION COSTS

This example is provided as an aid to understanding and does not form part of the Financial Reporting Standard.

Paragraph 87 of the Explanation suggests that, for major acquisitions, management may wish to include in the notes to the financial statements the amount of reorganisation and other costs to be incurred in relation to the acquisition. The following example indicates one way in which this optional information might be presented. The best form of the disclosure will depend on individual circumstances.

COSTS OF REORGANISING AND INTEGRATING ACQUISITIONS

	Acquisition of European business (note (a))	Other acquisitions	TOTAL
	£ million	£ million	£ million
Announced but not charged as at the previous year-end	–	25	25
Announced in relation to acquisitions during the year	170	–	170
Adjustments to previous years' estimates	–	(5)	(5)
	170	20	190
Charged in the year			
– operating profit	55	12	67
– elsewhere	65	–	65
	120	12	132
Announced but still to be charged at 31 December 1995	50	8	58

Note (a): Acquisition of European business

		£ million
Cost of acquisition		400
Reorganisation and integration expenditure announced		
Fundamental restructuring:		
– withdrawal from existing US business and related redundancies	65	
Other items (to be charged to operating profit):		
– other redundancy costs	75	
– re-branding and redesign costs	30	
Announced reorganisation and integration costs as shown in above table		170
Total investment		570

In addition to the £120 million expenditure shown in the above table, reorganisation and integration costs charged during the year include £30 million in respect of write-downs to fixed assets consequent on the closure of the XYZ plant.

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