

7

FAIR VALUES IN
ACQUISITION ACCOUNTING



ACCOUNTING
STANDARDS
BOARD

FINANCIAL REPORTING
STANDARD

*Financial Reporting Standard 7
'Fair Values in Acquisition Accounting' is
issued by the Accounting Standards Board
in respect of its application in the United
Kingdom and by the Institute of Chartered
Accountants in Ireland in respect of its
application in the Republic of Ireland.*

**FINANCIAL REPORTING
STANDARD**

7

**FAIR VALUES IN
ACQUISITION ACCOUNTING**

Financial Reporting Standard 7 is set out in paragraphs 1-31.

The Statement of Standard Accounting Practice set out in paragraphs 4-31 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 32-85 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 7. The views of the member who dissented are set out in Appendix IV.

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SUMMARY

General

- a Financial Reporting Standard 7 'Fair Values in Acquisition Accounting' sets out the principles of accounting for a business combination under the acquisition method of accounting. Companies legislation requires the identifiable assets and liabilities of the acquired entity to be included in the consolidated financial statements of the acquirer at their fair values at the date of acquisition. The difference between these and the cost of acquisition is recognised as goodwill or negative goodwill. The results of the acquired entity are included in the profit and loss account of the acquiring group from the date of acquisition.

Fair values of identifiable assets and liabilities

- b The assets and liabilities recognised in the allocation of fair values should be those of the acquired entity that existed at the date of acquisition. They should be measured at fair values that reflect the conditions at the date of the acquisition.
- c The liabilities of the acquired entity should not include provisions for future operating losses. Changes in the assets and liabilities resulting from the acquirer's intentions or from events after the acquisition should be dealt with as post-acquisition items. Similarly, costs of reorganisation and integrating the business acquired, whether they relate to the acquired entity or the acquiring group, should be dealt with as post-acquisition costs and do not affect the fair values at the date of acquisition.
- d Fair values should be based on the value at which an asset or liability could be exchanged in an arm's length transaction. The fair value of monetary items should

take into account the amounts expected to be received or paid and their timing.

- e Unless they can be measured at market value, the fair values of non-monetary assets will normally be based on replacement cost, but should not exceed their recoverable amount as at the date of acquisition. The recoverable amount reflects the condition of the assets on acquisition but not any impairments resulting from subsequent events. The FRS specifies the methods for determining fair values of individual categories of assets and liabilities.

Investigation period and goodwill adjustments

- f The identification and valuation of assets and liabilities acquired should be completed, if possible, by the date on which the first post-acquisition financial statements of the acquirer are approved by the directors. If it has not been possible to complete the investigation of fair values by that date, provisional valuations should be made; these should be amended if necessary in the next financial statements with a corresponding adjustment to goodwill.

Cost of acquisition

- g The cost of acquisition is the amount of cash or cash equivalents paid and the fair value of other purchase consideration given by the acquirer, together with the expenses of the acquisition. The FRS explains the methods used to determine the amounts to be ascribed to constituent parts of the purchase consideration.
- h Where the payment of consideration for an acquisition is to be made after the date of acquisition, reasonable estimates of the amounts expected to be paid should be included in the cost of acquisition at their present values.

FINANCIAL REPORTING STANDARD 7

OBJECTIVE

- 1 The objective of this FRS is to ensure that when a business entity is acquired by another, all the assets and liabilities that existed in the acquired entity at the date of acquisition are recorded at fair values reflecting their condition at that date; and that all changes to the acquired assets and liabilities, and the resulting gains and losses, that arise after control of the acquired entity has passed to the acquirer are reported as part of the post-acquisition financial performance of the acquiring group.

DEFINITIONS

- 2 The following definitions shall apply in this FRS and in particular in the Statement of Standard Accounting Practice set out in paragraphs 4–31.

Acquisition :-

A business combination that is accounted for by using the acquisition method of accounting.

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.

Date of acquisition :-

The date on which control of the acquired entity passes to the acquirer. This is the date from which the acquired entity is accounted for by the acquirer as a subsidiary undertaking under FRS 2 'Accounting for Subsidiary Undertakings'.

Fair value :-

The amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Identifiable assets and liabilities :-

The assets and liabilities of the acquired entity that are capable of being disposed of or settled separately, without disposing of a business of the entity.

Recoverable amount :-

The greater of the net realisable value of an asset and, where appropriate, the value in use.

Value in use :-

The present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from the ultimate disposal of the asset.

- 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

Scope

- 4 Financial Reporting Standard 7 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 the acquisition of a subsidiary undertaking by a parent company that prepares consolidated financial statements, it also applies where an individual company or other reporting entity acquires a business other than a subsidiary undertaking.

Determining the fair values of identifiable assets and liabilities acquired

Principles of recognition and measurement on an acquisition

- 5 The identifiable assets and liabilities to be recognised should be those of the acquired entity that existed at the date of the acquisition.
- 6 The recognised assets and liabilities should be measured at fair values that reflect the conditions at the date of the acquisition.

Application of the principles

- 7 As a consequence of the above principles, the following do not affect fair values at the date of acquisition and therefore fall to be treated as post-acquisition items:
 - (a) changes resulting from the acquirer's intentions or future actions;

- (b) impairments, or other changes, resulting from events subsequent to the acquisition;
 - (c) provisions or accruals for future operating losses or for reorganisation and integration costs expected to be incurred as a result of the acquisition, whether they relate to the acquired entity or to the acquirer.
- 8 The application of these principles to specific classes of asset and liability is detailed in paragraphs 9–22 below. Subject to those paragraphs, fair values should be determined in accordance with the acquirer's accounting policies for similar assets and liabilities.

Tangible fixed assets

- 9 The fair value of a tangible fixed asset should be based on:
- (a) market value, if assets similar in type and condition are bought and sold on an open market; or
 - (b) depreciated replacement cost, reflecting the acquired business's normal buying process and the sources of supply and prices available to it.

The fair value should not exceed the recoverable amount of the asset.

Intangible assets

- 10 Where an intangible asset is recognised, its fair value should be based on its replacement cost, which is normally its estimated market value.

Stocks and work-in-progress

- 11 Stocks, including commodity stocks, that the acquired entity trades on a market in which it participates as both a buyer and a seller should be valued at current market prices.
- 12 Other stocks, and work-in-progress, should be valued at the lower of replacement cost and net realisable value. Replacement cost is for this purpose the cost at which the stocks would have been replaced by the acquired entity, reflecting its normal buying process and the sources of supply and prices available to it—that is, the current cost of bringing the stocks to their present location and condition.

Quoted investments

- 13 Quoted investments should be valued at market price, adjusted if necessary for unusual price fluctuations or for the size of the holding.

Monetary assets and liabilities

- 14 The fair value of monetary assets and liabilities, including accruals and provisions, should take into account the amounts expected to be received or paid and their timing. Fair value should be determined by reference to market prices, where available, by reference to the current price at which the business could acquire similar assets or enter into similar obligations, or by discounting to present value.

Contingencies

- 15 Contingent assets and liabilities should be measured at fair values where these can be determined. For this purpose reasonable estimates of the expected outcome may be used.

Business sold or held exclusively with a view to subsequent resale

- 16 Where an interest in a separate business of the acquired entity is sold as a single unit within approximately one year of the date of acquisition, the investment in that business should be treated as a single asset for the purposes of determining fair values. Its fair value should be based on the net proceeds of the sale, adjusted for the fair value of any assets or liabilities transferred into or out of the business, unless such adjusted net proceeds are demonstrably different from the fair value at the date of acquisition as a result of a post-acquisition event. This treatment should be applied to any business operation, whether a separate subsidiary undertaking or not, provided that its assets, liabilities, results of operations and activities are clearly distinguishable, physically, operationally and for financial reporting purposes, from the other assets, liabilities, results of operations and activities of the acquired entity.
- 17 Where the business has not been sold by the time of approval of the first financial statements after the date of acquisition, the fair value of the interest in the business should be based on the estimated net proceeds of the sale, provided:
- (a) a purchaser has been identified or is being sought; and
 - (b) the disposal is reasonably expected to occur within approximately one year of the date of the acquisition.

The interest in the business or, if it is not a separate subsidiary undertaking, in the assets of the business, should be shown within current assets. When the sale price is subsequently determined, the original estimate of fair value should be adjusted to reflect the actual sale proceeds.

- 18 If the subsidiary undertaking or business operation is not, in fact, sold within approximately one year of the acquisition, it should be consolidated normally with fair values attributed to the individual assets and liabilities as at the date of acquisition, and corresponding adjustments to goodwill.

Pensions and other post-retirement benefits

- 19 The fair value of a deficiency or, to the extent that it is reasonably expected to be realised, a surplus in a funded pension or other post-retirement benefits scheme, or accrued obligations in an unfunded scheme, should be recognised as a liability or an asset of the acquiring group.
- 20 Changes in pension or other post-retirement arrangements following an acquisition should be accounted for as post-acquisition items and should be dealt with in accordance with the requirements of the standard concerned with pension costs.

Deferred taxation

- 21 Deferred tax assets and liabilities recognised in the fair value exercise should be determined by considering the enlarged group as a whole.
- 22 The benefit to the group of any tax losses attributable to an acquired entity at the date of acquisition should be recognised in accordance with the requirements of the standard concerned with deferred tax.

Investigation period and goodwill adjustments

- 23 The recognition and measurement of assets and liabilities acquired should be completed, if possible, by the date on which the first post-acquisition financial statements of the acquirer are approved by the directors.

- 24 If it has not been possible to complete the investigation for determining fair values by the date on which the first post-acquisition financial statements are approved, provisional valuations should be made; these should be amended, if necessary, in the next financial statements with a corresponding adjustment to goodwill.
- 25 Any necessary adjustments to those provisional fair values and the corresponding adjustment to purchased goodwill should be incorporated in the financial statements for the first full financial year following the acquisition. Thereafter, any adjustments, except for the correction of fundamental errors, which should be accounted for as prior period adjustments, should be recognised as profits or losses when they are identified.

Determining the cost of acquisition

- 26 The cost of acquisition is the amount of cash paid and the fair value of other purchase consideration given by the acquirer, together with the expenses of the acquisition as described in paragraph 28. Where a subsidiary undertaking is acquired in stages, the cost of acquisition is the total of the costs of the interests acquired, determined as at the date of each transaction.
- 27 Where the amount of purchase consideration is contingent on one or more future events, the cost of acquisition should include a reasonable estimate of the fair value of amounts expected to be payable in the future. The cost of acquisition should be adjusted when revised estimates are made, with consequential corresponding adjustments continuing to be made to goodwill until the ultimate amount is known.
- 28 Fees and similar incremental costs incurred directly in making an acquisition should, except for the issue costs of shares or other securities that are required by

FRS 4 'Capital Instruments' to be accounted for as a reduction in the proceeds of a capital instrument, be included in the cost of acquisition. Internal costs, and other expenses that cannot be directly attributed to the acquisition, should be charged to the profit and loss account.

Disclosures

- 29 The disclosures that should be made relating to an acquisition are set out in paragraphs 21 and 23–37 of FRS 6 'Acquisitions and Mergers'.

Date from which effective

- 30 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.

Amendment of SSAP 22

- 31 The FRS supersedes paragraphs 14, 23, 27, 30 and 33 of SSAP 22 'Accounting for goodwill'.

The following preamble is inserted in SSAP 22 before the Explanatory note:

"FRS 7 'Fair Values in Acquisition Accounting', published September 1994, supersedes paragraphs 14, 23, 27, 30 and 33 of this standard. Following publication of FRS 7, SSAP 22 is to be interpreted in the light of FRS 7; references to 'separable net assets' should be interpreted as 'identifiable assets and liabilities'.

FRS 6 'Acquisitions and Mergers', published September 1994, supersedes disclosure paragraphs 48–51; amended disclosure requirements are included in FRS 6."

EXPLANATION

Introduction

- 32 The FRS is consistent with the requirements of companies legislation regarding the acquisition method of accounting. It sets out principles for identifying the assets and liabilities of an acquired entity and determining their fair values, and for determining the cost of acquisition.
- 33 Under the acquisition method of accounting, the identifiable assets and liabilities acquired are recognised at their fair values as at the date of acquisition, and the difference between these and the cost of acquisition is accounted for as goodwill or negative goodwill.

Determining the fair values of identifiable assets and liabilities acquired

Existing assets and liabilities of the acquired entity

- 34 The identifiable assets and liabilities over which the acquirer obtains control are those representing rights to future economic benefits and obligations to transfer economic benefits, including contingent rights and obligations, of the acquired entity that were in existence before the date of acquisition.
- 35 The identifiable assets and liabilities may include items that were not previously recognised in the financial statements of the acquired entity. These include assets and liabilities that are not normally recognised in accounts where no acquisition is involved, because other accounting standards preclude their immediate recognition. Examples are:

- (a) pension surpluses or deficiencies identified on an acquisition that are otherwise recognised over several financial years in an entity's financial statements, in accordance with the requirements of SSAP 24 'Accounting for pension costs';
- (b) contingent assets that may be assigned a value on acquisition, but cannot otherwise be recognised in financial statements because SSAP 18 'Accounting for contingencies' precludes the recognition of a contingent gain until realisation becomes reasonably certain.

- 36** The examples given above are included in the identifiable assets and liabilities because when an acquisition is made it is necessary to identify and recognise, so far as possible, all assets and liabilities acquired, provided they can be reliably valued. If this is not done, the reporting of post-acquisition performance is distorted by changes in assets and liabilities not being recognised in the correct period. The usual accounting practice, for example, of deferring recognition of contingent assets, does not apply, because the recognition of an acquired asset represents the expectation that the amounts expended on its acquisition will be recovered; it does not anticipate a future gain. It is, however, necessary to review the recoverable amounts of such assets to ensure that provision is made for any probable losses.
- 37** Certain contingent assets and liabilities that crystallise as a result of the acquisition would also be recognised, provided that the underlying contingency was in existence before the acquisition. An example is where the acquired entity has previously entered into a contract that contains a clause under which obligations are triggered in the event of a change of ownership.

- 38 Identifiable liabilities include items such as onerous contracts and commitments that existed at the time of acquisition, whether or not the corresponding obligations were recognised as liabilities in the financial statements of the acquired entity. When an acquisition is made, provisions for liabilities would be recognised as identifiable liabilities only if such commitments had been made by the acquired entity before the date of acquisition. In the case of business closure decisions made by the acquired entity before the date of acquisition, the principles for recognising consequential provisions are set out in FRS 3 'Reporting Financial Performance', which states that obligations are incurred when there is a detailed formal plan for termination from which the entity cannot realistically withdraw*.

Exclusion of post-acquisition costs

- 39 The FRS does not permit provisions for future losses or for reorganisation costs expected to be incurred as a result of the acquisition to be included as liabilities acquired: they are not liabilities of the acquired entity as at the date of acquisition. As an example, if the acquirer decides to close a factory of the acquired entity as a measure to integrate the combined operations, this is a post-acquisition event. Only if the acquired entity was already committed to this course of action, and unable realistically to withdraw from it, would it be regarded as pre-acquisition. Similarly, if the acquirer undertakes a reorganisation to integrate the acquired operation or to improve its efficiency, this is also a post-acquisition event.

* FRS 3, paragraph 18.

- 40 Where provisions for future costs were made by an acquired entity shortly before an acquisition took place, for example during the course of negotiations with the acquirer, it would be necessary to pay particular attention to the circumstances in order to determine whether obligations were incurred by the acquired entity before the acquisition. Only if the acquired entity was demonstrably committed to the expenditure whether or not the acquisition was completed would it have a liability at the date of acquisition. If obligations were incurred by the acquired entity as a result of the influence of the acquirer, it would be necessary to consider whether control of the acquired entity had been transferred at an earlier date and, consequently, whether the date of acquisition under the requirements of FRS 2 'Accounting for Subsidiary Undertakings' pre-dated such commitments*. Under paragraph 26 of FRS 6 'Acquisitions and Mergers', disclosure is required of provisions made by the acquired entity within the twelve months preceding the date of acquisition.

Measurement of identifiable assets and liabilities

- 41 Most acquisitions are not made on the basis of individual transactions in assets and liabilities. The acquisition transaction does not itself determine the values attributed to each asset and liability acquired and for this reason companies legislation and accounting standards require a fair value exercise to determine initial carrying amounts of assets and liabilities on an acquisition.

* Under paragraph 45 of FRS 2 the date of acquisition may be indicated by the acquiring entity commencing its direction of the operating and financial policies of the acquired undertaking or by changes in the flow of economic benefits.

- 42 Although the FRS contains specific requirements for determining fair values of different classes of assets and liabilities, the concept of fair value underlying the specific rules is the value at which the asset, or liability, could be exchanged in an arm's length transaction between informed and willing parties.
- 43 Where similar assets are bought and sold on a readily accessible market, the market price will represent the fair value. Where quoted market prices are not available, market prices can often be estimated, either by independent valuations, or valuation techniques such as discounting estimated future cash flows to their present values. In some cases, where quoted market prices are not available, subsequent sales of acquired assets may provide the most reliable evidence of fair value at the time of the acquisition.
- 44 Where a fair value is based on a market price, it is important to ensure that such price is appropriate to the circumstances of the acquired business. For example, it may be possible to obtain a price for secondhand plant and machinery of the type used in the business, but the secondhand market may deal in very small volumes; or the items may not be identical in terms of the ability to obtain maintenance or technical support from the manufacturer or for the machinery to be customised to the requirements of the business. In general, unless the acquired business is genuinely able to consider the purchase of secondhand equipment as a viable alternative to purchasing direct from the manufacturer, the fair value of plant and machinery is more appropriately determined from the replacement cost of an equivalent new asset, depreciated where appropriate to reflect its age and condition.
- 45 The fair value attributed to an asset should not exceed the value the business is able to recover from the asset, either from its disposal or, in the case of a fixed asset,

by continuing to use the asset. Where the fair value is based on a market price, the net realisable value will be similar to the fair value, differing only by costs of realisation and the dealer's margin. However, where the fair value is based on depreciated replacement cost or cost of manufacture, the net realisable value and, in the case of a fixed asset, the value in use will also need to be considered.

- 46 Both net realisable value and value in use at the time of the acquisition are unaffected by the acquirer's intentions for the future use of the asset. Net realisable value represents the amount for which the business would be able to sell the asset, whether or not such sale is intended. Similarly, the value in use of a fixed asset at the time of the acquisition depends, not on the intended use, but on the most profitable possible use of the asset.

Impaired assets

- 47 Where the replacement cost of an acquired asset is not recoverable in full (owing, for example, to lack of profitability, under-utilisation or obsolescence), the fair value is the estimated recoverable amount. The FRS requires that a valuation at recoverable amount should reflect the condition of the asset on acquisition but not any impairments resulting from subsequent events.
- 48 Where acquired assets that had not been impaired before acquisition are disposed of after acquisition for a reduced price (for example, as part of a post-acquisition reorganisation of the enlarged group), any losses resulting from their disposal would be treated as post-acquisition losses, ie attributed to the reorganisation, and would not reduce the fair values as at the date of acquisition.

- 49 In some cases recoverable amount can be determined only by considering as a whole a group of assets that are used jointly, rather than by attempting to determine the recoverable amount of each identifiable asset in that group. Aggregation in such cases serves to facilitate the attribution of cash flows to the assets that help to generate them.

Tangible fixed assets

- 50 Where reliable market values are obtainable—for example, for quoted investments and certain types of property—fair value would be based on current market values of similar assets. As explained in paragraph 44 above, for many types of fixed asset—for example most plant and machinery, and specialised properties specific to the business—fair value is represented by gross replacement cost reduced by depreciation to take account of the age and condition of the asset. Depreciation rates need to reflect estimated asset lives and residual amounts used by the acquirer for similar types of asset; otherwise, without there being any change in the asset's use or intended use, the first post-acquisition profit and loss account would reflect the adjustment from the previous management's depreciation rate to the acquirer's depreciation rate.
- 51 For certain assets it is not easy to determine current replacement cost; neither is it possible to estimate the value of the future services that an asset can provide through its continued use, because of the inherent subjectivity of such a valuation. In such circumstances the historical cost of the asset updated by the use of price indices may be the most reliable means of estimating replacement cost. Where prices have not changed materially it would be acceptable to use a carrying value based on historical cost as a reasonable proxy for fair value.

Stocks and work-in-progress

- 52 Where stocks are replaced by purchasing in a ready market—for example, commodities and dealing stocks—to which the acquired entity has access, fair value is represented by market value. Where there is no ready market for a category of stocks—for example, most manufactured stocks—fair value is represented by the current cost to the acquired company of reproducing the stocks.
- 53 The FRS requires account to be taken of the way the acquired business purchased or manufactured the stocks. For example, for a business purchasing in wholesale markets the replacement cost would be the wholesale price; and the replacement cost of finished goods of a manufacturer will be the current cost of manufacture, not the cost of buying in finished goods from another manufacturer. Although this replacement cost takes account of the effects of input price changes during the period the stocks are held, no addition would be made for unrealised profit that would not normally be recognised in the acquired entity until the stocks are sold.
- 54 The current cost of manufacture for finished goods and work-in-progress would be based on current standard costs where these are employed. In practice, where there is a short manufacturing cycle, replacement cost may not be materially different from historical cost.
- 55 For long-term, maturing stocks, replacement cost would be based on market values if stocks at similar stages of completion are regularly traded in the market. In other cases, where such market transactions do not occur because either there is no market or the market is very thin, and where it is difficult to find replacement cost because replacement would be impossible in the short term, a surrogate for

replacement cost may be found in the historical cost of bringing the stocks to their present location and condition, including an amount representing an interest cost in respect of holding the stock.

- 56 For long-term contracts, SSAP 9 'Stocks and long-term contracts' requires turnover and cost of sales to be recognised as the contract progresses, and attributable profit to be recognised prudently as it is earned. For this reason, no adjustments to book values would be required to such contracts, other than adjustments that would normally result from assessing the outcome of the contract under SSAP 9, or reflecting the changeover to the acquirer's accounting policies.
- 57 In estimating the net realisable value of stocks, an acquirer may reach a judgement about the value of slow-moving or redundant stocks that differs from that of the management of the acquired entity. However, any material write-down of the carrying value of stocks in the acquired entity's books before or at the time of the acquisition would need to be justified by the circumstances of the acquired entity before acquisition. If exceptional profits appear to have been earned on the realisation of stocks after the date of the acquisition, it will be necessary to re-examine the fair values determined on acquisition as required by paragraphs 23–25 of the FRS and, if necessary, to make an adjustment to these values and a corresponding adjustment to goodwill. If, alternatively, the profit is attributable to post-acquisition events it should be disclosed as an exceptional item as required by paragraph 30 of FRS 6.

Quoted investments

- 58 The fair value of quoted investments will normally be their market price. However, it may be necessary to adjust the market price to allow for short-term fluctuations or, in the case of large holdings, to reflect

either a lower realisable value representing the difficulties of disposal or a higher value for a holding representing a substantial voting block.

Monetary assets and liabilities

- 59 Most short-term monetary assets and liabilities, including trade debtors and creditors, would be recognised at amounts expected to be received or paid on settlement or redemption.
- 60 The fair values of certain long-term monetary items may, however, be materially different from their book values. One example is where an acquired entity is carrying material amounts of long-term debt at fixed rates that do not reflect current borrowing rates. The fair value will be greater or lower than book value depending on the direction of changes in interest rates since the debt was issued. Another example is a material long-term debtor where the delay in settlement is not compensated by an interest charge reflecting current market rates.
- 61 The FRS requires monetary items to be stated at fair values where these are materially different from book values. Where the monetary item is a quoted security, its fair value is normally its market price. The fair values of other monetary items may be determined by considering the current terms on which a similar monetary asset or liability could be acquired or assumed, or by discounting to their present values the total amounts expected to be received or paid. The choice of interest rate to be applied to long-term borrowings would be affected by current lending rates for an equivalent term, the credit standing of the issuer and the nature of any security. For long-term debtors (after any necessary provisions have been made) the interest rate would be based on current lending rates.

- 62 The differences between fair values arrived at by discounting and the total amounts receivable or payable in respect of the relevant items represent discounts or premiums on acquisition that would be dealt with in the financial statements of the acquiring group as interest income or expense—that is, by allocation to accounting periods over the term of the monetary items at a constant rate based on their carrying amounts.
- 63 Where debt instruments issued by the acquired company are quoted, market values at the date of acquisition would be used instead of present values. However, in cases where a reduced pre-acquisition market value of an acquired entity's debt reflected the market's perception that it was at risk of being unable to fulfil its repayment obligations, the reduction would not be recognised in the fair value allocation if the debt was expected to be repaid at its full amount.

Contingencies

- 64 The value attributed to a contingent asset or liability needs to reflect the best estimate of the likely outcome; otherwise the post-acquisition profit and loss account will reflect the change from the previous management's estimate to the acquirer's estimate, without any related event or change in circumstances. In rare cases where a commitment or a contingent asset is of a kind that is normally assumed or acquired in an arm's length transaction (for example, underwriting commitments), its fair value would reflect the market price for such transactions.

Business sold or held exclusively with a view to subsequent resale

- 65 Where the acquisition of a group of companies includes a subsidiary undertaking or a discrete business operation that has been sold, or is expected to be sold,

as a single unit within approximately a year of the acquisition it is appropriate to treat the investment in this business as a single asset, and to assign a single fair value to the whole investment rather than assign individual fair values to the various assets and liabilities that are included in the operation to be sold. The asset the group acquires is regarded as the investment in the subsidiary undertaking or business operation, rather than the individual items; and the actual net realised value will normally provide the most reliable evidence of fair value at the date of acquisition. One effect of this treatment is that goodwill is effectively apportioned between the part of the acquired group that is to be kept and the part sold, with the result that no further adjustment to write off the goodwill relating to the business disposed of, to comply with UITF Abstract 3 'Treatment of goodwill on disposal of a business', would be necessary. Where the effect is material, the net proceeds would be discounted to obtain their present value at the date of acquisition (taking into account any distribution of profits from the business). The principle explained in paragraph 85 below for attributing expenses to the cost of an acquisition would also apply to the costs of disposals.

- 66 Where the disposal has not been completed at the time of the first financial statements after the acquisition, the fair value is based on the estimated sales proceeds. Any initial estimate of fair value would normally be adjusted to actual net realised value within the period allowed for completing the investigation of fair values, with the change being adjusted against goodwill.
- 67 Such intended disposals would neither have been previously consolidated by the acquirer, nor have formed a continuing part of the activities of the acquiring group. In these circumstances, for an interest

in a subsidiary undertaking, companies legislation* permits, and FRS 2 requires, the interest to be recognised as a current asset in the acquirer's consolidated accounts. The results of its operations during the holding period are excluded from the profit and loss account of the acquiring group.

- 68 The FRS requires the same principles of valuation to be applied to disposals of other business operations that are not subsidiary undertakings. Therefore, for example, the assets of a division held for resale would be shown as a single separately described current asset.
- 69 In the following circumstances it would be appropriate to estimate separately fair values at the acquisition date and to record a post-acquisition profit or loss on disposal:
- (a) the acquirer has made a material change to the acquired business before disposal;
 - (b) specific post-acquisition events occur during the holding period that materially change the fair value of the business from the fair value estimated at the date of acquisition; or
 - (c) the disposal is completed at a reduced price for a quick sale.

Pensions and other post-retirement benefits

- 70 The FRS requires that where an acquired entity sponsors a defined-benefit pension scheme, or a defined-benefit post-retirement scheme other than a

* In Great Britain, the Companies Act 1985, section 229(3)(c); in Northern Ireland, the Companies (Northern Ireland) Order 1986, Article 237(3)(c); and in the Republic of Ireland the European Communities (Companies: Group Accounts) Regulations 1992, Regulation 11(c).

pension scheme, the allocation of fair values should include an asset in respect of a surplus in a funded scheme and a liability in respect of a deficiency in a funded scheme or accrued obligations relating to an unfunded scheme. These assets or liabilities are in substitution for existing prepayments or provisions that have accumulated in the accounts of the acquired entity under the requirements of SSAP 24.

- 71 The fair value attributed to a surplus in a funded scheme would be determined by taking into account not only the actuarial surplus of the fund, but also the extent to which the surplus could be realised in cash terms, by way of reduction of future contributions or otherwise, and the timescale of such potential realisations.
- 72 This treatment differs from the normal requirements of SSAP 24, which in many circumstances do not permit the immediate recognition of assets and liabilities in respect of surpluses or deficiencies, but require them to be recognised systematically over the average remaining service lives of the employees in the scheme. Whilst SSAP 24 is primarily concerned with the allocation of pension costs to a company's profit and loss account on a continuing basis over several financial years, accounting for an acquisition transaction necessitates the recognition in the acquirer's group accounts of all assets and liabilities of the acquired entity identified at the date of acquisition. A pension asset, however, would be recognised only insofar as the acquired entity or the acquirer was able to benefit from the existing surplus.
- 73 The valuation of the pension fund surplus or deficit depends on several assumptions: interest rates, inflation and investment returns; the likely turnover of staff; and future salary increases; and the acquirer would apply its own judgement in determining these assumptions. However, the FRS requires changes in pension or other

post-retirement arrangements following an acquisition to be accounted for as post-acquisition items. An example is the cost of improvements to benefits granted to members of an acquired scheme as part of a policy of harmonising remuneration packages in the enlarged group. This treatment is consistent with accounting for any changes stemming from the acquisition that affect the pension arrangements of the acquirer's own workforce, and has the effect of treating changes in pension arrangements on the same basis as the realignment of any other aspects of remuneration. The cost of post-acquisition changes to pension and other post-retirement arrangements would be dealt with in accordance with the requirements of SSAP 24 relating to variations in pension cost.

Deferred taxation

- 74 Deferred tax has to be determined on a group basis; at the end of the accounting period in which the acquisition occurred, the enlarged group's deferred tax provision will be calculated as a single amount, on assumptions applicable to the group. To determine the deferred tax of the acquired company at the date of acquisition using different assumptions from those applying to the group as a whole would result in the post-acquisition profit and loss account reflecting the change from one set of assumptions to another, rather than any real change in the circumstances of the group.
- 75 The benefit to the group of any tax losses in an acquired entity at the date of acquisition would be recognised on acquisition in accordance with the requirements of SSAP 15 'Accounting for deferred tax'. The losses would therefore be treated as timing differences, and would be recognised as reductions in deferred tax liabilities (if any), with any remainder recognised as deferred tax assets provided that the criteria for recognition specified in SSAP 15 are met.

Application of these principles may result in deferred tax assets that were previously unrecognised in the acquired entity's financial statements being recognised on acquisition. If the criteria for the recognition of the benefits of tax losses in the group financial statements are not met as at the date of acquisition or within the permitted period for completing the fair value exercise, the benefits (if any) will be recognised in post-acquisition periods when the criteria are met, and any necessary disclosure required by paragraph 23 of FRS 3 will be given.

Determining the cost of acquisition

Fair values of the components of the purchase consideration

- 76 In order to apply the requirements of the FRS, it is necessary to determine the fair values of the constituent parts of the purchase consideration. The purchase consideration may comprise:
- (a) cash or other monetary items, including the assumption of liabilities by the acquirer;
 - (b) capital instruments issued by the acquirer, including shares, debentures, loans and debt instruments, share warrants and other options relating to the securities of the acquirer; or
 - (c) non-monetary assets, including securities of another entity.

Cash and other monetary consideration

- 77 Where the purchase consideration is in the form of cash or other monetary assets given or liabilities assumed, its fair value is normally readily determinable as the amount paid or payable in respect of the item. When settlement of cash consideration is deferred, fair values are obtained by discounting to their present

value the amounts expected to be payable in the future. The appropriate discount rate is the rate at which the acquirer could obtain a similar borrowing, taking into account its credit standing and any security given.

Capital instruments

- 78 Where shares (and other capital instruments) issued by the acquirer are quoted on a ready market, the market price on the date of acquisition would normally provide the most reliable measure of fair value. Where control is transferred by a public offer, the relevant date is the date on which the offer or, where there is a series of revised offers, the successful offer becomes unconditional, usually as a result of a sufficient number of acceptances being received. Where, owing to unusual fluctuations, the market price on one particular date is an unreliable measure of fair value, market prices for a reasonable period before the date of acquisition, during which acceptances could be made, would need to be considered.
- 79 Where securities issued by the acquirer are not quoted or, if they are quoted, the market price is unreliable owing, for example, to the lack of an active market in the quantities involved, it would be necessary to make a valuation of those securities. The fair value would be estimated by taking into account items such as:
- (a) the value of similar securities that are quoted;
 - (b) the present value of the future cash flows of the instrument issued;
 - (c) any cash alternative to the issue of securities; and
 - (d) the value of any underlying security into which there is an option to convert.

Where it is not possible to value the consideration given by any of the above methods, the best estimate of its value may be given by valuing the entity acquired.

Non-monetary consideration

- 80 Where the purchase consideration takes the form of non-monetary assets, fair values would be determined by reference to market prices, estimated realisable values, independent valuations, or other available evidence.

Contingent consideration

- 81 The terms of an acquisition may provide that the value of the purchase consideration, which may be payable in cash, shares or other securities at a future date, depends on uncertain future events, such as the future performance of the acquired company. An example is an 'earn-out', where consideration payable to the vendor takes the form of an initial payment, together with further payments based on a multiple of future profits of the acquired company. By its nature, the fair value of such contingent consideration cannot be determined precisely at the date of acquisition. The FRS requires that the cost of acquisition should include a reasonable estimate of its fair value. Where it is not possible to estimate the total amounts payable with any degree of certainty, at least those amounts that are reasonably expected to be payable would be recognised. Initial estimates would be revised as further and more certain information becomes available.
- 82 Where contingent consideration is to be satisfied by the issue of shares, there is no obligation to transfer economic benefits and, accordingly, amounts recognised would be reported as part of shareholders' funds, for example as a separate caption representing

shares to be issued. In the analysis of shareholders' funds, amounts would be attributed to equity and non-equity interests depending on the nature of the shares to be issued, in accordance with FRS 4 'Capital Instruments'. When the shares are issued, appropriate transfers would be necessary between any amounts then held in shareholders' funds in respect of their issue and called up share capital and share premium.

- 83 If the acquirer can satisfy part of the consideration by the issue of shares or the payment of cash at its option, this part of the future consideration is not a liability because there is no obligation to transfer economic benefits. Consequently, the expected future consideration would be accounted for as a credit to shareholders' funds as explained in paragraph 82 above until an irrevocable decision regarding the form of consideration has been taken. If, however, the vendor has the right to demand cash or shares, the expected future consideration represents an obligation to the vendor and would be accounted for as a liability until the shares are issued or the cash is paid.
- 84 Acquisition agreements may require payments to be made in various forms, for example as non-competition payments or as bonuses to the vendors who continue to work for the acquired company. In such circumstances, it is necessary to determine whether the substance of the agreement is payment for the business acquired, or an expense such as compensation for services or profit sharing. In the first case the expected payments would be accounted for as contingent purchase consideration; in the other case the payments would be treated as expenses of the period to which they relate.

Acquisition expenses

- 85** Acquisition expenses to be treated as part of the cost of acquisition include incremental costs such as professional fees paid to merchant banks, accountants, legal advisers, valuers and other consultants. Such expenses exclude any allocation of costs that would still have been incurred had the acquisition not been entered into—for example, the costs of maintaining an acquisitions department or management remuneration; such costs would be charged to the profit and loss account as incurred. Expenses of issuing shares and other capital instruments that qualify as issue costs as defined in FRS 4 would be dealt with in accordance with the requirements of that standard. Such expenses are not added to the cost of acquisition.

ADOPTION OF FRS 7 BY THE BOARD

Financial Reporting Standard 7 – ‘Fair Values in Acquisition Accounting’ was approved for issue by a vote of seven of the eight members of the Accounting Standards Board. Mr Main dissented. His dissenting view is set out in Appendix IV.

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

- 1 The Companies Act describes the acquisition method of accounting in Schedule 4A paragraph 9:
 - (a) The identifiable assets and liabilities of the undertaking acquired shall be included in the consolidated balance sheet at their fair values as at the date of acquisition. The 'identifiable' assets or liabilities of the undertaking acquired mean the assets or liabilities that are capable of being disposed of or discharged separately, without disposing of a business of the undertaking (Schedule 4A paragraph 9(2)).
 - (b) The income and expenditure of the undertaking acquired shall be brought into the group accounts only as from the date of the acquisition (Schedule 4A paragraph 9(3)).
 - (c) There shall be set off against the acquisition cost of the interest in the shares of the undertaking held by the parent company and its subsidiary undertakings the interest of the parent company and its subsidiary undertakings in the adjusted capital and reserves of the undertaking acquired. The resulting amount if positive shall be treated as goodwill, and if negative as a negative consolidation difference (Schedule 4A paragraph 9(4)-(5)).
 - (d) The 'acquisition cost' is defined as the amount of any cash consideration and the fair value of any other consideration, together with such

amount (if any) in respect of fees and other expenses of the acquisition as the company may determine; and 'the adjusted capital and reserves' of the undertaking acquired are defined as the capital and reserves at the date of the acquisition after adjusting the identifiable assets and liabilities of the undertaking to fair values as at that date (Schedule 4A paragraph 9(4)).

Share premium and merger relief

- 2 Section 130(1) of the 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 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.
- 3 Limited relief from the above ('merger relief') is given by sections 131-134.
- 4 Section 131 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 that takes the holding in that other company to at least 90 per cent.
- 5 Section 133(1) provides that the premium on any shares to which the relief in sections 131 and 132 applies may also be disregarded in determining the amount at which any shares or other consideration provided for the shares issued is to be included in the offeror company's balance sheet.

Share premium and fair value

- 6 Shares forming part of the consideration are valued at their fair value for the purposes of computing acquisition cost and goodwill under paragraph 9(4) of Schedule 4A. By contrast, the value of the share premiums arising on the shares issued, for the purposes of section 130, is based on the value to the issuing company of the consideration it has received. Where these values are different, or where (if the merger relief provisions apply) the premiums are disregarded, the cost of investment in the parent company's books will be different from the cost of acquisition for the purposes of paragraph 9(4). In such circumstances the difference should form a separate element of consolidated reserves, and does not form part of goodwill.

Northern Ireland

- 7 The legal requirements in Northern Ireland are very similar to those in Great Britain. The following table shows the references to the Companies (Northern Ireland) Order 1986 that correspond to the legal references in paragraphs 1-6 above.

*Great Britain**Northern Ireland*

Schedule 4A paragraph 9

Schedule 4A paragraph 9

Sections 130-134

Articles 140-144

Republic of Ireland

- 8 The following table shows the references to the European Communities (Companies: Group Accounts) Regulations 1992 and the Companies Act 1963 that correspond to the legal references in paragraphs 1-6 above.

Great Britain

Republic of Ireland

Schedule 4A paragraph 9

Regulation 19

Section 130

Companies Act 1963
section 62

Sections 131–134

No equivalent

APPENDIX II

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

The International Accounting Standards Committee (IASC) has issued a revised standard IAS 22 'Business Combinations'. The principal areas where the revised IAS 22 and the FRS are at variance* are as follows. First, the revised IAS 22 requires that fair values of identifiable assets and liabilities acquired in an acquisition should be determined by reference to their intended use by the acquirer. The FRS requires the identifiable assets and liabilities to be recorded at their fair values as at the date of acquisition. Secondly, certain adjustments that would be treated as fair value adjustments under the revised IAS 22, for example those for additional liabilities recognised to reflect an acquirer's different intentions regarding an acquisition, would be accounted for as post-acquisition items under the FRS.

* The Board's reasons for adopting proposals that differ from those of the IASC's revised IAS 22 are set out in Appendix III, at paragraphs 15-16 and 27-28.

APPENDIX III

THE DEVELOPMENT OF THE FRS

General and history

- 1 The principle of attributing fair values in consolidated financial statements to the assets and liabilities of newly acquired subsidiaries has been recognised in UK accounting standards for many years and, since 1989, in companies legislation.

SSAP 14

- 2 SSAP 14 'Group accounts', which was published in 1978, required the purchase consideration for the acquisition of a subsidiary to be allocated between the underlying net tangible and intangible assets other than goodwill on the basis of the fair value to the acquiring company. The standard gave no guidance on how to determine fair values.

SSAP 22

- 3 SSAP 22 'Accounting for goodwill', issued in 1984, gave limited guidance on how to identify the assets and liabilities of an acquired business that should be regarded as separable from the purchased goodwill arising on the acquisition. It also sanctioned the practice that had evolved of adjusting the fair values ascribed to the separable net assets acquired to include provisions for anticipated future losses or costs of reorganisation. Such provisions were permitted to be recognised in the fair value exercise if the future losses or costs were taken into account in arriving at the purchase price.

- 4 Subsequently, however, concern among users began to emerge over the extent to which the use of provisions could potentially be hidden or abused. The Accounting Standards Committee (ASC) took action to address these concerns by amending SSAP 22 to include some specific disclosure requirements relating to the fair value exercise. The revised SSAP 22, published in 1989, required disclosure of adjustments made to the book values of the assets and liabilities of an acquired business, analysed into revaluations and provisions. It also required disclosure of movements on provisions related to acquisitions, analysed into the amounts used and the amounts released unused or applied for another purpose. At the same time as SSAP 22 was being amended, the ASC was developing an accounting standard on fair value accounting (see paragraph 6 below).

Companies Act 1989

- 5 The Companies Act 1989 introduced a new Schedule 4A to the Companies Act 1985, which set out rules regarding the form and content of consolidated financial statements. The Act requires that, in accounting for the acquisition of a subsidiary, the subsidiary's identifiable assets and liabilities must be included in the consolidated balance sheet at their fair values as at the date of acquisition. There is no guidance in the Act on how to determine the fair values of assets and liabilities acquired.

ED 53

- 6 The ASC issued a discussion paper in 1988, followed in 1990 by an exposure draft, ED 53 'Fair value in the context of acquisition accounting'. ED 53 contained proposals for determining fair values of assets and liabilities identified in an acquisition, for dealing with anticipated reorganisation costs and for valuing the consideration given for an acquisition.

- 7 ED 53 proposed that fair values should be determined from the perspective of the acquiring company, based on circumstances at the date of acquisition. Its proposals for dealing with acquisition provisions did not permit provision to be made for future trading losses of acquired businesses but did, however, continue to permit provisions for reorganisation costs to be made as fair value adjustments if there was a clearly defined programme of reorganisation that had been costed in reasonable detail and there was evidence that the acquirer took account of the plans and costs in formulating the offer.

ASB Discussion Paper

- 8 In April 1993, the Board published a Discussion Paper, 'Fair values in acquisition accounting'. The Board adopted much of the work of the ASC in framing its proposals, but concluded that a different approach to the recognition of liabilities was necessary to address a number of issues, including those raised in responses to ED 53. A theme common to several of the commentators' responses had been that the basic principles underlying ED 53's approach had not been properly developed and in particular that the exposure draft had failed to rationalise its conclusions on key issues such as the recognition of reorganisation and future loss provisions.
- 9 The Discussion Paper contained proposals that attempted to draw a clear distinction of principle between recording the elements of the purchase transaction, including accounting for the pre-acquisition assets and liabilities of the acquired business, and the items that should fall into the post-acquisition period. The proposals would have precluded provisions both for future losses in acquired businesses and, as a departure from ED 53, for reorganisation costs following an acquisition from being included as fair value adjustments. The principal

reasons for proposing such a radical change to existing practices were threefold:

- (a) the proposals for dealing with the recognition of anticipated future losses and reorganisation costs were consistent with the Board's draft Statement of Principles regarding the recognition of liabilities;
- (b) the proposals were consistent with the philosophy behind the 'information set' approach in FRS 3 'Reporting Financial Performance' in respect of presenting the financial effects of post-acquisition activities, including reorganisation of acquired businesses;
- (c) to meet users' concerns on perceived scope for abuse; it was doubtful whether an alternative approach of developing a standard founded on enhanced disclosure of acquisition provisions, supplemented by specific and probably arbitrary rules on cut-off between pre- and post-acquisition items would prove as effective in the long term as an approach built on the Board's draft Statement of Principles.

FRED 7

- 10 FRED 7 was published in December 1993. It retained the essential features of the proposals in the Discussion Paper, while refining and clarifying them to take account of the comments received.
- 11 Views on the proposal in the Discussion Paper that all costs of reorganising acquired businesses should be treated as charges to post-acquisition profits had been divided, with a small majority in favour of the proposed treatment. Support had been strongest among user groups, who generally welcomed the transparency of the proposals in providing a proper

basis for analysing the financial consequences of acquisition activities. Opposition had been voiced by many—although by no means all—preparers, who argued that the proposals belied the reality of the way acquisitions are handled because they failed to reflect the fact that the cost of an acquisition and subsequent, directly related expenditure are the product of a single investment decision. As an example, many commentators had argued that the costs incurred in the immediate post-acquisition period to implement a business plan to reorganise an acquisition were probably discrete and significant and were an integral part of the investment appraisal process; such costs, they contended, should not be reported in the group's trading results. The purchase and integration of a subsidiary, in their eyes, was in substance a single capital transaction, despite the fact that some elements might be revenue in form.

- 12 The Board set out in FRED 7 the basis for its conclusions on the proposed treatment of post-acquisition reorganisation costs. The main arguments, which are equally applicable to the FRS, are summarised as follows.
 - (a) The proposals were made in the context of the fundamental changes to the disclosure of financial performance that were introduced by FRS 3. If a company incurs material revenue expenditure to improve future profitability, the costs are normally charged to the profit and loss account. FRS 3 and the Operating and Financial Review both provide the facility for proper disclosure and explanation of the resulting volatility in the reported results. The Board believed that all such expenditure should be treated similarly, whether it related to a reorganisation following an acquisition or to a reorganisation of an ongoing business. It would be left to investment analysis to assess the benefit to an entity of a reorganisation.

- (b) The proposals in respect of the recognition of liabilities were consistent with the Board's draft Statement of Principles. The approach rested on whether there was an obligation in the acquired entity at the acquisition date. The Board recognised that, where an acquisition was made, the acquirer might have taken into account additional costs to reorganise the operations of the combining entities and such costs might have been factored into the investment decision and the amount of purchase consideration to be offered. However, it did not follow that these costs should be deemed to increase the liabilities of the acquired entity existing at the acquisition date.
- (c) The proposals, which required reorganisations related to acquisitions to be treated on the same footing as any other reorganisations, set out principles that avoided the need to define cut-off points between items to be included in the fair value exercise and items to be recognised in the post-acquisition period, which would have been difficult to achieve. Framing an alternative approach on the basis of the acquirer's intentions at the time of the acquisition would, in the Board's opinion, have led to artificial distinctions being drawn not only between the treatment of reorganisations affecting the acquired business and consequential changes in the existing business of the acquirer, but also between reorganisations that were planned at the time of acquisition and those that occurred later.
- 13 Many commentators had argued that the 'acquirer's perspective' should be retained as a principle for attributing fair values to the assets and liabilities acquired. They had contended that because the purchase consideration was based on the acquirer's assessment of the fair value of the acquired entity and

its underlying assets and liabilities, it followed that the allocation of the purchase consideration should also be based on the acquirer's perspective.

- 14 The Board is of the view that under its draft Statement of Principles, management intent is not a sufficient basis for recognising changes to an entity's assets and liabilities. It is events, not intentions for future actions, that increase or decrease an entity's assets or liabilities. When intentions are translated into actions that commit the entity to particular courses of action, the accounting should then reflect any obligations or changes in assets that arise from those actions. In relation to acquisition accounting, the Board concluded that events of a post-acquisition period that resulted in the recognition of additional liabilities or the impairment of existing assets of an acquired entity should be reported as events of that period rather than of the pre-acquisition period.
- 15 Some commentators expressed concern that the proposals for precluding any reorganisation provisions as fair value adjustments were more restrictive than the requirements in the USA or International Accounting Standards. They urged the Board to go no further than to achieve consistency with US GAAP which, although not permitting provisions for future losses of acquired companies to be recognised as fair value adjustments, would allow adjustments to be made to take account of management intentions in the valuation of acquired assets, including, for example, provisions in respect of the intended closure of facilities in the acquired entity that are duplicated in the enlarged group.
- 16 In developing FRED 7, the Board took into account the fact that US GAAP in this area considerably pre-dates the development of the present framework of general accounting concepts in the USA, as well as the IASC

framework and the UK draft Statement of Principles, which are similar. The Board took the view that its proposals were consistent with the conceptual frameworks that had been developed elsewhere and, in particular, noted that the principle of accounting for obligations rather than management intentions was gaining greater acceptance internationally.

Matters considered in the light of responses to FRED 7

- 17 The following paragraphs refer to comments made by respondents to FRED 7, and explain with reasons the changes the Board has made to the proposals of the FRED or the Board's reasons for rejecting arguments for changes. Individual Board members gave greater weight to some factors than to others.

Reorganisation provisions

- 18 FRED 7 proposed that the identifiable assets and liabilities recognised in the fair value exercise should be those of the acquired entity that existed at the date of acquisition, and should include provisions neither for future operating losses nor for reorganisation and integration costs expected to be incurred as a result of the acquisition.
- 19 This proposal met with outright support from institutional investors, analysts and users of accounts; substantial support from accountancy firms and accountancy bodies; and strong, though not unanimous, opposition from preparers of accounts.
- 20 The main arguments raised by respondents opposed to the proposals in the FRED are summarised below, together with the Board's response to the arguments.

Commercial reality

- 21 It was argued that the FRED ignored the commercial reality of the transaction, namely that the acquirer's management takes the reorganisation and integration costs into account in its 'project plan' for the acquisition, and regards these costs as part of the 'investment'; they should therefore be treated as akin to additional consideration. Furthermore, it was argued, under the FRED's proposals the acquisition of a poorly organised business that is then reorganised by the acquirer gives a different accounting result from the acquisition of an equivalent but well-organised business that is not in need of reorganisation.
- 22 Of those who preferred the status quo on reorganisation provisions, most agreed that the existing situation was unsatisfactory and that tighter definitions and controls were needed; in particular, there was little support for continuing to allow provisions to be made for future losses of the acquired business, and most agreed that there should be rules to restrict the use of reorganisation provisions made as fair value adjustments.
- 23 The Board has carefully reconsidered the arguments against its proposals, which reiterated the arguments raised by a majority of preparers against the proposals in the Discussion Paper. The Board recognises the strength of feeling held in some quarters against this aspect of its proposals, which changes long-standing accounting practice. It has also balanced these views with those of user and other groups who supported the proposals. While not discounting the reasons or rationale underlying the position of those opposed to its proposals, the Board decided that it should develop an FRS on the basis of the proposals in FRED 7. It believes that this FRS will lead to clearer and more consistent reporting than has been the case under existing practices. Furthermore, the Board remains of

the view that the approach adopted in the FRS is more soundly based on principle than would be an alternative approach that sought to improve existing standards by addressing disclosure issues and developing detailed rules that had the principal objective of constraining reorganisation provisions solely in order to prevent abuse.

- 24 Without repeating all the arguments underlying the Board's position as set out in FRED 7, the Board reaffirms that the principles in the FRS for determining the fair values of the assets and liabilities of the acquired entity adhere closely to the Board's draft Statement of Principles in respect of the recognition of assets and liabilities, and to the philosophy behind FRS 3 (complemented by the Operating and Financial Review) for reporting financial performance and other gains and losses.
- 25 The FRS, therefore, follows the principle (as set out in the draft Statement of Principles) that identifiable liabilities are limited to obligations of the acquired entity that existed at the date of acquisition and, consequently, other changes should fall into the post-acquisition period. The Board recognises that rationalisation expenditures, whether to improve or to integrate part of the business following an acquisition, are undertaken because they are expected to result in lasting and long-term benefits. However, in the Board's view this does not justify the effective capitalisation of that expenditure as goodwill, irrespective of whether it was planned at the time of the acquisition or whether the plans were formulated after the acquisition took place.
- 26 The Board also takes the view that the acquisition of a well-organised company is a different transaction from the acquisition of a company in need of reorganisation, and there is no reason why the two transactions should result in the same accounting

outcome. In one case the acquirer is reporting the acquisition of a business whose previous management ran it efficiently; in the other, the acquirer is reporting the acquisition of a less efficient business and the subsequent expenditure intended to improve it. In the first case, the success of the business was apparent before the acquirer agreed to buy it; in the second, the value of the reorganisation expenditure will be judged subsequently by the increase in profitability of the acquired business that is achieved.

International competitiveness and international GAAP

- 27 It was suggested by some respondents that the FRED's approach, by being stricter in some respects than the corresponding provisions of accounting standards in other countries (in particular, US GAAP and the International Accounting Standard) would damage the competitiveness of UK companies. Conversely, others have argued that the existing flexible accounting practices in the UK have encouraged UK companies to overpay for acquisitions compared with foreign companies. The Board takes the view that accounting standards should be neutral as to economic effect. Therefore, the FRS seeks to provide greater clarity in the reporting of acquisition activities. The more transparent accounting resulting from the FRS and from other accounting reforms that the Board has undertaken should contribute to sound economic decisions.
- 28 The Board carefully considered the international harmonisation issue during the development of FRED 7. As noted in paragraph 16 above, the Board believes that the FRS is consistent with the conceptual frameworks that have been adopted by various standard-setting bodies.

'Socio-economic' consequences

- 29 Some respondents also claimed that acquirers will be less willing to acquire companies in need of reorganisation, thus allowing inefficient management to remain and preventing rationalisation that is beneficial to the economy as a whole. However, the Board notes that the cash flow effect of a transaction is the same whichever accounting treatment is adopted.

Understandability of financial statements

- 30 Several preparers of accounts suggested that the reporting of acquisitions would be more difficult to understand, because the full cost to the acquirer will not be clear and the post-acquisition results will be distorted by reorganisation and integration costs. However, users who responded were unanimous that the FRED's proposals would provide them with clearer and more informative information on acquisitions.
- 31 In response to those commentators who argued that the financial statements should be capable of showing the full cost of the investment in an acquisition, including the intended costs of post-acquisition reorganisation, the FRS has introduced a recommendation that the planned reorganisation expenditure relating to the acquisition should be disclosed in the notes to the financial statements (see paragraph 40 below).

Anti-avoidance measures

- 32 There was concern that the requirements of the FRS could be circumvented by collusion between the vendor and the acquirer, resulting for example in the vendor entering into obligations to restructure the business on the instructions of the acquirer before the formal transfer of control.

- 33 The Discussion Paper had proposed that any reorganisation provisions made by the vendor in the six months before the acquisition should be treated as post-acquisition; however, this was generally regarded as unnecessarily draconian and was omitted from the FRED.
- 34 The FRS deals with the issue in three ways. First, it emphasises that provisions should be included in the balance sheet of the acquired company at the date of acquisition only if that entity had a commitment from which it could not realistically withdraw whether or not the acquisition had been completed. Secondly, it draws attention to the possibility that the effective transfer of control took place at an earlier date than the formal transfer of shares. Thirdly, there is an additional disclosure requirement (included in FRS 6) for any provisions for reorganisation made by the acquired company within 12 months before the date of acquisition to be shown separately in the 'fair value table'.

Conclusion

- 35 The Board gave careful consideration to the arguments of those opposed to the proposals in the FRED, and acknowledged the strength of feeling particularly among many preparers of accounts. However, it concluded that the arguments put forward were essentially those it had already addressed in coming to its initial views expressed in the Discussion Paper and FRED 7. Moreover, where the arguments concern the understandability of financial statements, due regard must be given to the views of the professional users of accounts—in particular, the institutional investors and analysts, who were fully in support of the proposals.

Other issues

'Acquirer's perspective'

- 36 Several respondents (including both some of those who supported the FRED's approach to reorganisation provisions as well as some of those who opposed it) argued that the fair values should be determined from the 'acquirer's perspective'. However, the Board took the view that this term had no single clear meaning, and might be interpreted to indicate that fair values should take into account the decisions of the acquirer taken after the acquisition. For this reason, the Board has avoided using the term in the FRS, but has added more specific descriptions of the extent to which the acquirer's estimates and perceptions are taken into account in determining fair values. The concept of fair value underlying these specific rules remains, however, the value at which the asset, or liability, could be exchanged in an arm's length transaction between informed and willing parties. This concept is independent of the particular circumstances of either the acquirer or the acquired business.

Disclosure of provisions for reorganisation costs

- 37 Several respondents were concerned that, if reorganisation and similar costs relating to an acquisition were reported in the profit and loss account in accordance with the provisions of FRS 3, such costs might be reported as a deduction from the results of acquisitions, or as part of continuing activities; or, if they related to a fundamental reorganisation of the acquiring entity, as an exceptional item outside operating profit. Users might therefore find it difficult to ascertain the total costs relating to acquisitions. Instead, they proposed that a new category of exceptional item should be defined, to include all costs of reorganisation, restructuring and integration relating to an acquisition, that would not form part of operating profit.

- 38 The Board concluded that this alternative proposal would confuse different kinds of costs relating to acquisitions, some of which might properly be excluded from operating profit but others of which were just as much an operating cost as the costs of routinely reorganising an existing part of the business. Furthermore, the introduction of a new class of exceptional item would lead to considerable difficulties of definition, as in many cases it was difficult to draw a clear distinction between costs relating to the acquisition, and similar costs relating to the acquirer's existing business that might well still have been incurred had the acquisition not taken place.
- 39 The Board therefore decided against introducing a new class of exceptional item. FRS 6, which now includes all disclosure requirements relating to acquisitions, sets out in paragraph 86 how the requirements of FRS 3 apply to costs relating to acquisitions.
- 40 In addition, paragraph 87 of FRS 6 suggests that management may wish to show, in a note to the financial statements, the total expenditure announced in relation to reorganisation and integration of acquisitions, together with the expenditures charged in the profit and loss account in the period and the further amount expected to be incurred. This would provide users with a clear statement of the total costs involved with the acquisition, and companies would be able to add what further explanation and discussion of the figures they think appropriate.

Pension surpluses

- 41 The FRED proposed that an actuarial surplus or deficit on a pension scheme operated by the acquired company should be recognised as an asset or liability on acquisition. Many respondents thought it

imprudent to carry such a surplus as an asset, as it was often uncertain whether it could be realised. They therefore proposed that, whilst provision should still be made for a deficit, a surplus should not be recognised as an asset.

- 42 The Board has reconsidered the issue, and concluded that, although recognition of a surplus is consistent with the principles on which the FRS is based, it is important that the fair value attributed to such a surplus is justified. The FRS therefore requires the fair value of a surplus to be determined taking into account the extent to which, and timescale over which, the surplus is reasonably expected to be realised, normally in the form of reductions in future contributions.
- 43 The Board is currently reviewing the existing accounting standard on pension costs, SSAP 24. However, the Board decided that to omit reference to pension surpluses and deficits in the FRS, or to require fair values to be based on the assets or liabilities recognised by the acquired company in its own accounts under SSAP 24, might result in the omission of significant assets and liabilities and subsequent misstatement of profits of the enlarged group.

Acquisition expenses

- 44 The FRED proposed that the amount of incidental expenses that fall to be treated as an addition to the cost of acquisition should be restricted to incremental costs that would not have been incurred had the acquisition not taken place, and did not permit the capitalisation of internal costs even where they might be directly related to the acquisition. This proposal was consistent with the revised IAS 22 and US GAAP, and took a deliberately restrictive view to avoid the danger of overstating the cost of acquisition.

- 45 An alternative view is that the incremental cost approach is anomalous where the equivalent services, such as legal advice or acquisition search and investigation services, are provided by in-house departments rather than by external advisers or consultants.
- 46 There was substantial support from respondents for each view. The Board concluded that the difficulty of defining 'incremental' for in-house facilities might lead to excessive costs being capitalised, with the resulting overstatement of profits. This outweighed the possible anomalies that might arise. The proposals in the FRED have accordingly been carried through to the FRS.

Discounting

- 47 The FRED proposed that monetary assets and liabilities should be discounted to present value where they were materially different from nominal amounts. Although this was supported, a substantial minority of respondents were concerned over the introduction of discounting on a piecemeal basis, applying only to assets and liabilities of an acquisition, rather than as part of a more general application of discounting to all assets and liabilities.
- 48 The Board has reaffirmed its view that monetary assets and liabilities acquired in an acquisition should be included at their fair value at the time of the acquisition; this fair value will depend on the estimated amounts and timing of payments, and, in the case of long-term items not bearing interest at current market rates, may be materially different from their face value or nominal value. Significant distortions to reported profits may arise if such items are not included at their fair value. Discounting is an established and widely used valuation technique, and is one method of arriving at an estimate of fair value. The Board notes that this treatment is also consistent with the revised IAS 22 and with US GAAP.

APPENDIX IV

DISSENTING VIEW

- 1 Mr Main dissents from the FRS because of its treatment of the costs an acquiring company incurs to convert an acquired entity into the business unit it envisaged when making the acquisition. He was content at the exposure draft stage to let the proposal go forward in order to elicit a public response. However, he has found his concern reinforced by comments received and therefore feels unable to vote for the FRS.
- 2 Mr Main believes that it is very rare for a company to acquire another without intending to make changes to the acquired business to enable it to operate efficiently. Such changes may include, on the one hand, investment in, and reorganisation of, the assets being acquired to enable products or services to be provided efficiently, and, on the other hand, reductions of excessive manpower, buildings or equipment to enable an adequate profit to be earned.
- 3 Mr Main believes that the need for such changes and the likely cost of executing them are invariably known to the acquirer at the time the acquisition is made, and that the normal practice of management when considering a proposed acquisition for approval is to aggregate the acquisition price with these costs of bringing the acquired entity into a state acceptable to the buyer, in order to arrive at the investment total against which the expected earnings are judged.
- 4 The requirements of the FRS will prevent a company from recognising in the financial statements at the time of acquisition the costs of the intended changes. It is only when such costs are committed irrevocably that they are to be included in the financial statements, and even then, to the extent that these costs are not capital expenditure, they cannot be included as part of the investment cost of the acquisition.

- 5 For these reasons the financial statements will, in his view, be misleading and fail to provide accountability for the transactions that have taken place.
- 6 Mr Main supports the view expressed by many commentators on the Discussion Paper and exposure draft, as set out in paragraphs 11 and 21 of 'The development of the FRS' (Appendix III), that the costs of an acquisition and subsequent directly related expenditure are the product of a single investment decision; and that the purchase and integration of a subsidiary are in substance a single capital transaction. He believes that the opposition to this view by certain commentators reflected less an endorsement of the principles underlying the FRS than a reaction to perceived abuses in previous practice, including the making of excessive acquisition provisions to cover future trading losses and types of expenditure whose relationship to the acquisition was remote. He would summarise the responses to the exposure draft on this point as follows:

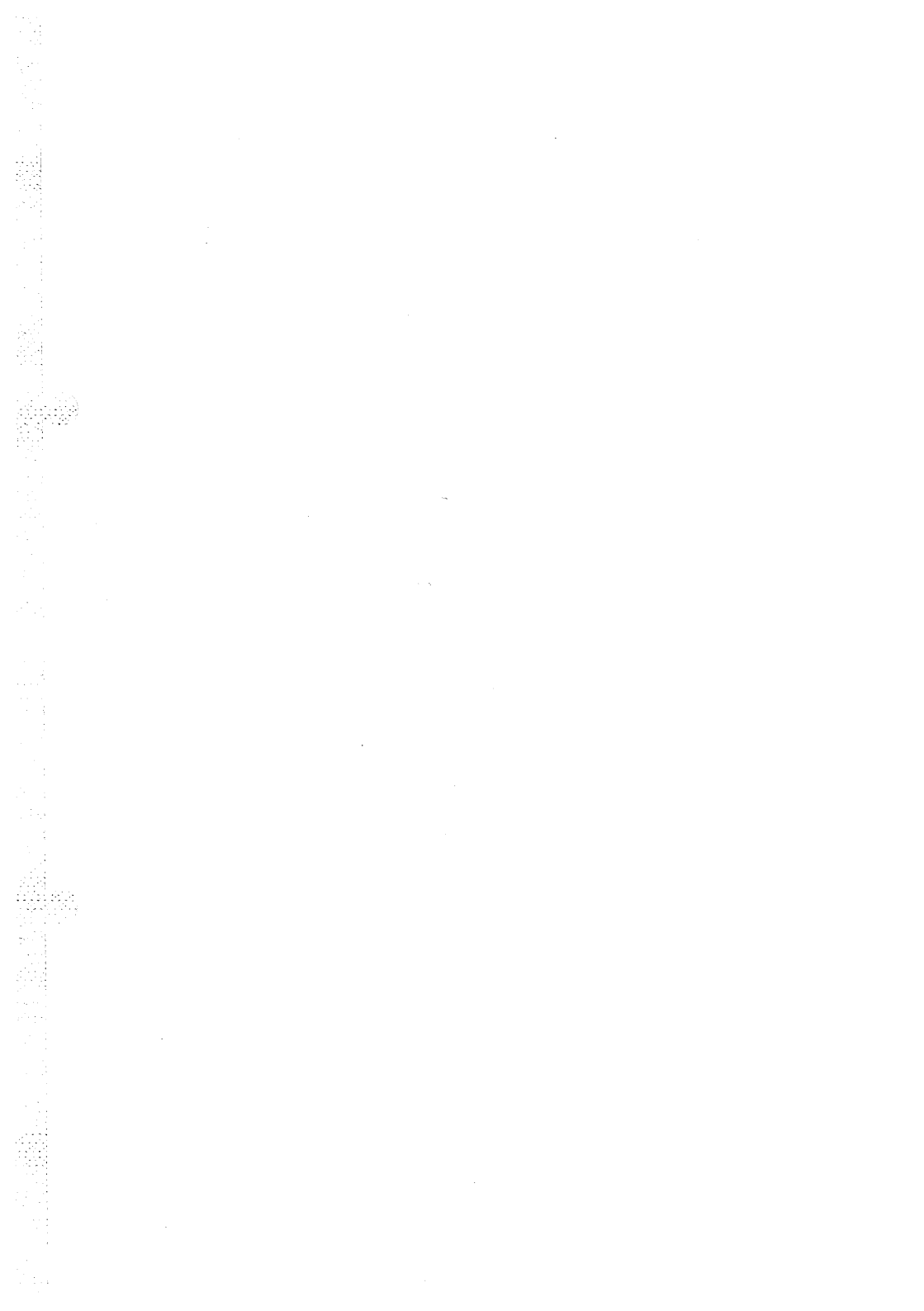
- | | |
|---------------------------------|--|
| (a) from preparers of accounts: | overwhelming opposition; |
| (b) from users: | acceptance, because they want to know the amount of post-acquisition provisions (which he considers to be a valid point), but a view that they would ignore the amounts charged against profits (indicating that they do not regard such charges as a proper reduction of profit); |

(c) from auditors: acceptance, because it can be very difficult at times to pass judgement on directors' decisions as to the proper capital provision for post-acquisition costs.

7 Mr Main believes that the concerns over past abuses could be met, without overturning long-standing practice, by a standard that provided a stricter definition of what costs should be permitted to be included in acquisition provisions, together with more detailed note disclosure of the provisions made. Provisions would be restricted to costs to be incurred within twelve months of the acquisition, and would exclude any costs relating to the acquiring entity's own activities. Provisions for future losses would also be prohibited. Notes to the financial statements would be required to disclose the separate elements of the provisions involved and the actual expenditure subsequently charged against the provisions. Surplus provisions would be required to be adjusted against goodwill rather than be released to the profit and loss account. He believes that the disclosure requirements in the related FRS 6 would provide sufficient information on the effects of an acquisition without the need for the radical change in practice introduced in FRS 7.

8 Mr Main believes that his alternative would ensure that:

- (a) the total cost of the acquisition investment decision would be reflected clearly in the financial statements;
- (b) accountability could be measured; and
- (c) the potential for abuse would be removed and auditors would have a clear standard against which the contents of the provision could be judged.



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