Guidance on Accounting for Business Combinations within the Public Sector

Summary

1. The purpose of this paper is to advise those public bodies to whom the Government Financial Reporting Manual (FReM) applies of the correct accounting treatment for business combinations under common control[1] and to draw together guidance on other linked financial reporting requirements. This includes the following types of business combination:

    a. Machinery of Government[2] changes, as defined by in the Ministerial Code and reproduced as part of the Cabinet Office's MoG handbook, and consistent with Supply Estimates Guidance Manual;

    b. Other transfers of function under common control, including those resulting from the public service reform agenda where service functions continue to be performed within the public sector.

2. Public bodies that are incorporated as companies or that have charitable status should follow this guidance in so far as it is consistent with statutory guidance.

Financial reporting changes: 2012-13 onwards

3. The accounting treatment of business combinations under common control has been amended in the 2012-13 FReM. The FReM does permit alternative accounting with Relevant Authority agreement, subject to this treatment being applied symmetrically by the transferee and transferor.

4. **Prospective application** – This accounting policy change should be made prospectively, on the basis that retrospective application of this change, which may require restatement of some prior year transfers of function, will not add value to the comparability of financial statements.

FReM application of IFRS 3, Business Combinations

5. IFRS 3 excludes from its scope business combinations involving entities or businesses under common control. In 2012-13 the FReM states that:

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[1] Common control for the public sector context refers to the European System of Accounts (ESA 95) term 'general government'. This is applied by the ONS for national accounts purposes and it is used by Treasury to define control for budget purposes. General Government includes those bodies classified to central goverrnment, local government and Public Corporations.

[2] A MoG change occurs where a transfer function occurs:

- between Ministers in charge of departments unless the changes are de-minimis, can be made administratively and do not justify public announcement;
- within the field of responsibility of one Minister when the change is likely to be politically sensitive or to raise wider issues of policy or organisation;
- between junior Ministers within a department when a change in ministerial titles is involved.

"...The combination of two or more public sector bodies into one new body, or the transfer of functions from the responsibility of one part of the public sector to another, will be accounted for as a Transfer by Merger." [2012-13 FReM paragraph 4.2.14].

6. This treatment provided comparative information on service performance within the public sector for users of the accounts. The principles apply insofar as the application does not contravene legislation and other statutory accounting guidance.

7. The rise in public sector restructuring has brought to light practical, accountability and in some cases, legal obstacles to accounting for all transfers by merger. An amendment to this application of merger accounting was made in October 2012, to improve user understanding of service performance and rationalise reporting requirements. The 2013-14 FReM states that:

   "The combination of two or more public sector bodies into one new body, or the transfer of functions from the responsibility of one part of the public sector to another, will be accounted for as either a Transfer by Merger or as a Transfer by Absorption". [2013-14 FReM paragraph 4.2.14].

8. The **'transfer by merger'** accounting treatment should be applied for transfers of function between departmental-groups within central government, but not between a Westminster Department and the Welsh Government, Northern Ireland Assembly or Scottish Government. That is, for transfers at the group-level, whose income and expenditure is controlled directly by Parliamentary Supply processes (departmental group accounts), or the devolved equivalent Supply process. The treatment requires the transfer to be accounted for as if the function had always taken place in the transferees accounts.

9. The accounting for all other public sector business combinations should be as a **'transfer by absorption'**, whereby transferor and transferee financial statements are adjusted at carrying value from the date of transfer. This adjustment represents a non-operating gain or loss on transfer.

Clarification of the FReM application:

10. A definition of a business combination, also known as a function has now been provided in the FReM:

    "an identifiable business operation with an integrated set of activities, staff and recognised assets and/ or liabilities that are capable of being conducted and managed to achieve the objectives of that business operation." [FReM paragraph 4.2.15)

    A transfer of function may not always include all of these features, and where there is uncertainty, both parties, auditors and the Relevant Authority should be involved in discussions to determine the classification.

11. A decision-making flow chart is provided at Appendix 1 to clarify the treatment where a transfer does not meet the definition of a function or is not under common control, and under what circumstances a transfer of function under common control should be accounted for as a Transfer by Merger or by Absorption.

12. **Restatement of comparative information** - Where comparative restatement is required under merger accounting, this should be done in accordance with IAS 1 as interpreted by the FReM. IAS 1 (paragraph 39) requires as a minimum, three statements of financial position,

two each of the other primary statements, and related notes. The statements of financial position should be presented as at the end of the current period, the end of the previous period and the beginning of the earliest comparative (i.e. previous) period as stated in the FReM at paragraph 4.2.19.

13. Consideration should be given to the **materiality** and **cost-benefit** of producing performance information. Specific issues should be discussed with the relevant HM Treasury contacts and agreed with the NAO.

14. A scenario analysis is provided at Appendix 2 to provide practitioners with a guide to the expected accounting treatment. This list is not absolute and practitioners should contact the Relevant Authority if they are uncertain of the treatment.

Accounting and Verification of Accounting Data

General

15. Irrespective of whether a business combination (transfer of function) under common control has been accounted for as a Transfer by Merger or Transfer by Absorption, at the whole of government level, nothing has changed. The function is still undertaken; it is only the entity that performs the function that has changed.

16. The following guidance outlines the verification work necessary to ensure that accounting data transferred under a Transfer by Merger or Transfer by Absorption change are complete and accurate. For comparison, the accounting requirements of a Business Combination not under Common Control (i.e. acquisition accounting under IFRS 3), are also provided.

Comparison of Accounting treatments

17. The following table provides a summary of the respective accounting treatments. This should assist you in identifying what information the transferor and transferee will need to obtain for the transferring function(s).

Accounting Impact	**Acquisition accounting**	**Transfer by Merger**	**Transfer by Absorption**
Summary of treatment	Accounts reflect the acquired entity's results from the date of acquisition only.	Group accounts reflect the combined entity's results as if they had always been combined.	A new/renamed entity is created or an existing entity or function transfers to the other entity. The transferor and transferee account for the function up to/ from the point of transfer.
Valuation of assets/ liabilities	Acquiring entity must attribute 'fair values' to the identifiable assets and liabilities of the acquired business at the date of acquisition and use these as the initial carrying values (or 'cost') in the group SoFP. Any gains or losses arising from this revaluation are recognised in the acquired entity's SoCNE or reserves prior to consolidation	No restatement of the value of assets and liabilities is required. The existing values (CV) retrospectively reported in the group SoFP, adjusted only to harmonise accounting policies. Revaluation reserves and accumulated depreciation should also be transferred.	No restatement of assets and liabilities is required. The existing carrying values (CV) are reported in the transferee's SoFP and adjusted (through reserves) only to harmonise accounting policies with those of the new entity. Revaluation reserves and accumulated depreciation should

	and thus are not recognised as a gain or loss in the combined entity's post acquisition SoCNE or reserves.		also be transferred.
Impact on Income/ Expenditure	Any difference between the fair values of the acquired company's net assets and the consideration given for them by the acquiring company will give rise to Goodwill on consolidation. Any positive goodwill must be recognised as an asset on the SoFP and reviewed annually for impairment. Unlike FRS 6, negative goodwill, or bargain purchase, must be recognised immediately as a gain, with positive goodwill amortised over a suitable period.	No goodwill arises in merger accounting as there is retrospective restatement..	No goodwill arises in absorption accounting, reflecting the fact that there is no market for this transfer. The net movement is accounted for as non-operating gains/losses from the transfer of function, through Net Expenditure
Reporting Standard Guidance	Accounting requirements directed principally by IFRS 3.	Accounting requirements directed principally by IFRS 3 scope limitation and therefore FRS 6 (UK GAAP) as per the Relevant Authority Memorandum of Understanding and IAS 8.	Accounting requirements not directed by legislation or the Relevant Authorities accounting hierarchy (IFRS, IPSAS, UK GAAP), but implicitly allowed under IAS 8.

Impact of Transfers

18. Transfers of function under common control can have a significant impact on the accounts, budgets and estimates of the transferee if the data pertaining to the assets and liabilities of the transferring function are not accurate. It is in the interests of both the transferor and the transferee to ensure such data are accurate so as to prevent post-transfer disputes between the two parties.

19. Both the transferor and the transferee should disclose in the financial statements that the transfer has taken place, the date of transfer, the name of the transfer party and the effect on the financial statements.

Sharing Information

20. For Transfers by Merger:

- The transferor should provide to the transferee a Statement of Financial Position (SoFP) for the transferring function as at the 1st April of the financial year of transfer, a statement of financial position for the function as at the date of transfer and prior year comparatives, as required by IAS 1, *Presentation of Financial Statements*;

- The transferor should reconcile the balances in the closing SoFP with those in the opening SoFP, detailing the transactions and cash flows that have occurred between the two dates; and

- Both parties should note that the assets and liabilities stated in the 1st April SoFP will be those included in/excluded from the audited accounts. Where a transfer of functions occurs on the 1st April, the transferor will only need to provide a SoFP for the transferring function at this date.

21. For Transfer by Absorption:

- The transferor should provide to the transferee a SoFP for the transferring function up to the point of transfer i.e. prosepctively.

- To ensure transfer information is applied correctly, both parties should reconcile the balances in the closing SoFP with those absorbed into the SoFP of the transferee, detailing the transactions and cash flows.

- The transferor should present additional information in the SoFP to provide clarity of the impact of the transfer on its assets, liabilities and equity. For example, the transferor could provide an additional statement of financial position to enable reporting of the pre and post-transfer (i.e. nil balance sheet) position in closing audited accounts or provide additional narrative to explain the impact of the transfer.

- The transferor should also make available comparative information to the transferee, if the transferee considers it necessary to report historical service performance to enable users to understand operational performance.

Statement of Financial Position

22. The transferee should satisfy itself that the data provided by the transferor relating to the assets and liabilities being transferred are complete and accurate. As a general rule the transferee should satisfy itself that:

For assets:

- All assets exist;
- Their values are based on International Financial Reporting Standards (IFRS), adapted and interpreted for the public sector context and promulgated in the FReM; and
- The values assigned to such assets are materially correct.

For liabilities:

- All liabilities are stated;
- Their values are based on IFRS, adapted and interpreted for the public sector context and promulgated in the FReM; and
- The values assigned to such liabilities are materially correct.

23. Transferees should consider what specific checks might be necessary. Some guidance on the sort of issues that should be considered is included in the checklist below.

Statement of Comprehensive Net Expenditure and Cash

24. For **Transfers by Merger**, the transferee will be required to remit to the transferor the net cash expended by the transferor on the function during the financial year. It is important that the transferee satisfies itself that it is only settling in cash the net amount paid out to date by the transferor in respect of the function by ensuring that the transactions and cash flows for the year to date are accurate.

Accounting for assets in a Transfer by Absorption

25. For **transfers by absorption**, where an entity is the recipient in the transfer of a function, it recognises the assets and liabilities received as at the date of transfer. The assets and liabilities are not adjusted to fair value prior to recognition. The corresponding net credit/debit reflecting the gain/loss is recognised within income/expenses, but outside of operating activities.

26. The pre-transfer income, expenses, assets and liabilities of the reporting entity are not adjusted to include any pre-transfer activity of the function.

27. For property, plant and equipment assets and intangible assets, the Cost and Accumulated Depreciation/Amortisation amounts from the transferring entity's accounts are preserved when the assets are recognised in the reporting entity's accounts.

28. Where any assets received had an attributable revaluation reserve balance in the transferring entity's accounts, this is preserved in the reporting entity's accounts by it transferring the relevant amount from its general fund reserve to its revaluation reserve.

> Example:
> During the financial year, an NDPB (A) is the recipient of a transfer of a function from another NDPB (B), which meets the definition of a machinery of government change. The function is received on 1 February. The net assets received are £40m. These net assets have an associated revaluation reserve balance in NDPB B's accounts of £12m.
>
> On 1 February NDPB A recognises the £40m net assets in its Statement of Financial Position. It also recognises a gain of £40m which it records as income.
>
> This income is material and therefore the NDPB A presents it in the Statement of Comprehensive Net Expenditure as a separate item within the overall net expenditure (i.e. above Other Comprehensive Expenditure).
>
> NDPB A then transfers £12m from its general fund reserve to its revaluation reserve, and reports this transfer in the Statement of Changes in Taxpayers' Equity.

29. Where, instead the reporting entity is the body transferring the function, the opposite accounting entries apply. It de-recognises the assets and liabilities as at the date of transfer and recognises the corresponding net debit/credit as a loss/gain in

expenses/income but not within operating activities. Any revaluation reserve balances attributable to the assets transferred are removed from the revaluation reserve and transferred to the general fund reserve.

Timing of data verification work

30. The transferor and transferee should agree the asset and liability balances being transferred as quickly as is reasonably possible. The transferor should provide access to information, staff and premises as necessary. Ideally, the transferee should aim to complete its due diligence[3] work within two months of the date the transferor provides the necessary data (opening and closing SoFP etc.). The transferor should in turn provide this data as quickly as it is reasonably possible. Regardless, the transferee's due diligence work will need to be completed in time for any Supplementary Estimates to be prepared to effect a Machinery of Government change or other budget changes.

Involving Auditors

31. Accounting issues resulting from transfers will require audit, you should seek the involvement of your auditor at the earliest possible stage of the process.

Further Guidance

32. Further guidance on reporting Transfers by Merger (including Machinery of Government Changes) on OSCAR is available in the OSCAR user manual.

33. Further HM Treasury guidance on the budgetary and Estimates requirements of business combinations under control, and how these requirements should be met, should be sought from the relevant HM Treasury representative.

Details Checklist for MoG and other transfers of Assets and Liabilities:

Asset/Liability	Checks for Transfers by Merger and Transfers by Absorption (including all MoGs)
Tangible Non-current Assets	• Are book values accurate? • What was the result of the last Non-current asset verification? • For all material items (and all land and buildings) consider undertaking external professional valuation (internal valuers could be employed). • Are all reserves and accumulated depreciation relating to transferring assets identifiable and transferred separately to the General Fund Reserve?
Intangible Non-current Assets	• Are book values accurate? • Do assets exist (i.e. development assets – is process/product still is use? Software licences – is software still used?) • For difficult valuations (i.e. income model) consider external valuation.
Financial assets and	• Assets should be assessed against financial instrument reporting

3 Due diligence in this context is information gathering to assess risks inherent within individual organisations party to a merger or to the merged organisation itself.

financial liabilities	standards as interpreted in the FReM • Is the asset held on behalf of government? • Is the asset or liability a loan, PDC or interest in a public body outside the departmental boundary? • Is the liability a financial guarantee contract or an insurance contract? • Have financial instruments valued at fair value been discounted correctly? • Has the asset or liability been assessed for embedded derivatives? • Are all reserves relating to transferring assets identifiable?
Inventories	• Are inventory values accurate? • Does inventory exist? • Is there any obsolete or slow moving inventory impacting on inventory provisioning? • What condition is it in / is it still useful? • What was the result of the last inventory stock take?
Trade and other receivables	• Are receivables recoverable? • What percentage of debt is irrecoverable? • Is the process for recognising and derecognising receivables sound? • Is there a bad debt provision, if so, is it reasonable? • What is the ageing profile of receivables? • Is the transferor in dispute with any of its receivables?
Trade and other payables	• Is the payable figure accurate and complete? • Is the process for recognising and derecognising trade and other payables sound? • Is the transferor in dispute with any of its trade and other payables?
Provisions	• Is the process for recognising and measuring provisions sound - present obligation as a result of a past event, probable outflow and reliably estimated? • Is the process for capturing provisions sound? • Consider external valuation of material provisions.

Appendix 1

Decision-making flowchart – FReM Accounting for Business Combinations

Is a function or service transfer identifiable?

No

Apply FReM paragraph 6.2.23 (asset transfers) where there is no service or function transfer associated with the transfer of assets between any two or more bodies.

Yes

Is this transfer of service or function between two bodies classified to the public sector?

No

Apply IFRS 3 in full where the transferee or transferor of the service or function is not classified to the public sector – there is no common control.

Yes

Does legislation associated with the restructuring restrict the accounting treatment application?

Yes

Apply the specified accounting treatment, with additional disclosure where this is not aligned to FReM guidance.

No

Does the transfer of service or function take place with a body:

- outside of central government (i.e. with a body classified by ONS to local government or as a public corporation (finance or non-finance))?; or
- across devolved governments within the central government sector?

No

The transfer takes place within central government (excluding movement across devolved governments).

Does the transfer take place within a Departmental Group?

Yes

Account as a **Transfer by Absorption.**

This also applies to Trading Funds.

No

- Account at the **Group level** (i.e. departmental accounts) as a **Transfer by Merger**
- Account at the **Agency or ALB (NDPB)** level as a **Transfer by Absorption.**

Yes

There is no overall impact on the Departmental Group performance statement, therefore, all bodies should accounting for transfers as **Transfers by Absorption** (Core department, Agency and ALB individual accounts.)

Note – The accounting should prescribed in this flowchart should be applied by both parties involved in the transfer, in accordance with the guidance issued by the Relevant Authority.

Proposed FReM Amendment - Scenario Analysis **Appendix 2**

The table below provides a summary of the expected accounting treatment when applying the 2013-14 FReM and flow chart guidance. The underlying objective is to ensure the financial reporting supports the accountability for the transferring function, and to do so in a symmetrical way to ensure there is no transparency gap.

Type of Function Transfer	Accounting treatment for the transferor	Accounting treatment for the transferee
Dept A is transferred into Dept B & C	**Transfer by Merger** under a MoG change – Dept A will not produce closing accounts. Accounting responsibilities are transferred to Dept B & C.	**Transfer by Merger** under a MoG change – Dept B&C will report the performance of the transferred function from the beginning of the reporting period, with retrospective restatement.
A function of Dept A is transferred to ALB* A	The Departmental Group position is unchanged as a result of the transfer, therefore **Transfer by Absorption accounting** should normally be applied by the Core Department to identify the change within the Group and ensure accounting entries are pragmatic. Performance recognition in the Core Department column should cease on transfer.	**Transfer by Absorption**. Prospective performance recognition by ALB A from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve. The symmetrical application should ensure the Group Statement of Financial Position is unaffected by the transfer.

A function of Dept A is transferred to ALB B, controlled by Dept B	**Transfer by Merger** under a MoG Transfer of Function order where statutory responsibilities have changed. The financial statements will be restated to remove the service performance, with additional disclosure explaining the transfer	**Transfer by Merger** applied by Dept B. Whilst the ALB will only report prospectively, to ensure consistency at the departmental level and with budgets and Estimates, restatement is required to reflect the opposite entries to Dept A. **Transfer by Absorption** by the ALB. Prospective performance recognition by ALB A from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve. Dept B will need to ensure that sufficient data is available from Dept A and ALB B to carry out merger accounting at the group level.
ALB A is transferred into parent Dept A	**Transfer by Absorption.** ALB Closing accounts will be required disclosing performance up to the date of transfer, unless the transfer and closure occur at 31 March. For closures at 31 March, the transferee should prepare primary financial statements as normal. The Departmental Group position is unaffected by the transfer so a symmetrical accounting treatment should ensure the Group Statement of Financial Position is unaffected by the transfer.	The Departmental Group position is unchanged as a result of the transfer, therefore **Transfer by Absorption** should normally be applied by the Core Department to identify the change within the Group and ensure accounting entries are pragmatic. Performance recognition in the Core Department column should be prospective on transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve.

ALB A is transferred into ALB B, both within Department A	**Transfer by Absorption**. Closing accounts will be required for ALB A, disclosing performance up to the date of transfer, unless the transfer takes place at 31 March. There will be no overall impact on Dept A financial Statements, with consolidation of ALB A’s closing accounts (with a nil Statement of Financial Position) or year-end position for transfers at 31 March, and additional disclosure to explain the restructuring of controlled ALB’s,	**Transfer by Absorption**. Prospective performance recognition from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve. There will be no overall impact on Dept A financial Statements, with consolidation of ALB’s accounts and disclosure needed to explain the restructuring of controlled ALB’s.
ALB A is transferred from Dept A’s control to Dept B’s control	**Transfer by Merger** under a MoG Transfer of Function order where statutory responsibilities have changed. The financial statements will be restated to remove the service performance, with additional disclosure explaining the transfer. There is no impact on the ALB performance statements.	**Transfer by Merger** under a MoG Transfer of Function order where statutory responsibilities have changed. The financial statements will be restated to include the retrospective service performance, with additional disclosure explaining the transfer There is no impact on the ALB performance statements.
ALB A is closed and service split between Dept A and Dept B	**Transfer by Merger** will apply to Dept A, retrospectively transferring part of the service out of the Departmental Group performance to Dept B. **Transfer by Absorption** will apply to the ALB and service remaining within the Dept A group. ALB Closing accounts will be required disclosing performance up to the date of transfer, unless the transfer and closure occur at 31 March. For closures at 31 March, the transferee should prepare primary financial statements as normal.	**Transfer by Merger** will apply to Dept B, reporting the performance of the transferred function from the beginning of the reporting period, with retrospective restatement. All Parties will need to agree that the ALB provides appropriate information to enable the transfer by merger to be accounted for correctly, where material.

Some of an ALB's functions are transferred to local government	**Transfer by Absorption.** Prospective performance de-recognition in both the ALB and parent Department from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve.	In accordance with the CIPFA-LASAAC Code, **a symmetrical accounting treatment** will apply to the local authority, with prospective performance recognition from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. There should be no impact on. local taxation.
A Trading Fund (Public Corporation) is transferred to within a Department	**Transfer by Absorption.** Closing accounts will be required (under Trading Fund Act 1973) disclosing performance up to the date of transfer. Transferred assets and liabilities will be derecognised at carrying value resulting in a nil-balance closing SoFP except for transfers and closures occuring at 31 March.	**Transfer by Absorption.** Prospective performance recognition from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve.
An ALB is transferred from Department A to a Devolved Administration	**Transfer by Absorption.** Prospective performance de-recognition in parent Department from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve. The financing provided by the Westminster Office of the Devolved Administration to the Devolved Administration is likely to change prospectively.	**Transfer by Absorption.** In accordance with guidance from the Relevant Authority, prospective performance recognition from the date of transfer, with net assets/liabilities recognised at carrying value in full through income/expenditure. Revaluation Reserves and accumulated depreciation should be transferred, with corresponding adjustments to the general fund reserve. The ALB will continue to report as normal, noting the change in sponsoring body.
Combinations of the above	Where transfers of service or function involve several restructuring processes, those significant to each body, within practicability constraints, should be recorded in accordance with the above treatments.	

*****All references to Arm's Length bodies (ALB) apply equally to NDPBs, Executive Agencies and any other subsidiary organisation consolidated within parent accounts, in accordance with the relevant guidance to that organisation.