



## Financial Reporting Advisory Board Paper

### NHS Foundation Trusts – accounting for mergers and acquisitions

<b>Issue:</b>	Proposed accounting treatment for mergers between NHS Foundation Trusts (FTs) and NHS Trusts, and for Acquisitions of NHS Trust activities by FTs.
<b>Impact on guidance:</b>	
<b>UK GAAP adaptation?</b>	Underlying principle is to adhere to UK GAAP
<b>IAS/IFRS compliant?</b>	N/A
<b>IPSAS compliant?</b>	N/A
<b>Impact on budgetary regime?</b>	No
<b>Recommendation:</b>	Approve the proposed treatments and the guidance to be included in the 2006/7 FT Financial Reporting Manual (FT FReM)
<b>Timing:</b>	2006/7

#### DETAIL

##### Background

1. The Health and Social Care (Community Health and Standards) Act 2003 (“the Act”) provides for the creation of NHS Foundation Trusts as public benefit corporations, to provide goods and services for the purposes of the health service in England.
2. Section 17 (4) of the Act provides that an FT may invest money for the purposes of or in connection with its functions. Investment may include investment by forming or participating in forming bodies corporate and otherwise acquiring membership of bodies corporate. A proposal for an FT to acquire, in whole or in part, another FT or NHS Trust or a private

sector business is dealt with by Monitor under its best practice advice “Risk Evaluation for Investment Decisions by NHS Foundation Trusts” published in February 2006.

3. Sections 27 and 28 of the Act provide for an NHS Trust and a Foundation Trust (“FT”) (or for two FTs) to submit a joint application to Monitor to merge. Under the Act, the existing bodies are dissolved and a new Foundation Trust is established. Monitor’s guidance for such mergers is set out in the Merger Guide to applicants dated 3 August 2006.
4. In addition to mergers two separate scenarios exist in the FT sector - where an FT Trust seeks to acquire the ‘business’ of an NHS Trust, or the acquisition of a private sector business by an FT. In both these scenarios the existing FT would remain in existence with the combined operations. In substance, the FT is conducting a takeover of the NHS Trust’s business, or the private sector business.
5. Monitor needs to set the accounting guidance for mergers and acquisitions by NHS FTs to include in the FT FReM for 2006/07. This paper outlines the accounting treatment that Monitor considers is most appropriate for the scenarios noted above, together with the proposed guidance to be included in the FT FReM with effect from 2006/07. The proposed accounting treatments are as follows:

<b>Type of business combination</b>	<b>Proposed accounting treatment</b>
Statutory merger using the mechanism set out in ss27 and 28 of the Act	Merger by absorption accounting
Acquisition of an NHS Trust’s ‘business’ by an FT acquisition of a private sector business by an FT or of an FT by an FT (not under ss27 and 28 of the Act)	Acquisition accounting
Merger of an NHS Trust’s business with an FT (not under ss27 and 28 of Act)	Merger accounting (very rare)

6. The key differences of each accounting treatment are set out in the table below:

<b>Acquisition accounting</b>	<b>Merger accounting</b>	<b>Merger by absorption</b>
Group accounts reflect the acquired entity's results from the date of acquisition only.	Group accounts reflect the combined companies' results as if they had always been combined.	The new entity's accounts reflect only its activities from the date of its inception.
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 balance sheet. Any gains or losses arising from this revaluation are recognised in the acquired entity's reserves prior to consolidation and thus are not recognised as a gain or loss in the combined entity's post acquisition reserves.	No restatement of assets and liabilities is required. The existing values are simply recorded in the group balance sheet, adjusted only to harmonise accounting policies, through adjustment to relevant balances and accumulated reserves.	No restatement of assets and liabilities is required. The demising entities' existing values are simply recorded in the new entity's balance sheet (to the extent that the functions have transferred) and adjusted only to harmonise accounting policies with the new entity's financial reporting framework.  In the past, with NHS Trusts, typically the capital and reserves of demising entities are extinguished and the new entity commences with public dividend capital only.
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 goodwill must be recognised as an asset on the balance sheet and amortised over a suitable period.	No goodwill arises in merger accounting.	No goodwill arises in fresh-start accounting.
Accounting requirements directed principally by Companies Act, FRS 6 and 7.	Accounting requirements directed principally by Companies Act and FRS 6.	Accounting requirements not directed by legislation or UK GAAP.

7. The Government FReM states that FRS 6 applies in full to all entities covered within its boundaries. FTs are not covered by the Government FReM but any divergences from the Government FReM must be approved by FRAB after consultation with the Treasury.

8. Whilst the Government FReM states FRS 6 applies in full, it continues to state that merger of two or more entities into one new entity, or the transfer of functions from the responsibility of one part of the Public Sector to another (commonly known as Machinery of Government changes), will be accounted for using merger accounting. This is because bodies covered by the FReM are considered to be under common control and such changes are viewed as group reconstructions.
9. There is no definition of Machinery of Government changes within the Government FReM, however practice suggests the following definition:

*“those stemming from the streamlining of the public sector where for reasons of improved service delivery functions are moved from one part of the public sector to another. This can be as wide as two large departments being brought together to form a new entity or as narrow as a small function moving from one department to another.”*

10. Monitor considers that where an FT acquires an NHS Trust this should not fall within the scope of ‘Machinery of Government changes’ for the following reasons:
  - the transaction may not meet the FRS 6 criteria for merger accounting as set out in paragraph 5 to 12 of FRS 6; and
  - the transaction does not meet the group reconstruction criteria set out in paragraph 13 of FRS 6;
  - Currently it is understood that PDC may not transfer between NHS Trusts and FTs, which would preclude the strict application of merger accounting;
  - the transaction will not result in a movement of functions across departmental boundaries

11. These reasons are further discussed below:

#### **FRS 6 criteria for merger accounting**

12. FRS 6 states that providing all five criteria are met a business confirmation should be accounted for using merger accounting. Monitor considers that it would be very rare for all five criteria to be met. In particular criterion 1, 2 and 3 are considered unlikely to occur in practice where an FT acquires an NHS Trust.

#### **Group reconstruction**

13. Paragraph 13 of FRS 6 states that a group reconstruction may be accounted for by using merger accounting, even though there is no business combination meeting the definition of a merger provided:
  - (a) the use of merger accounting is not prohibited by companies legislation
  - (b) the ultimate shareholders remain the same, and the rights of each such shareholder, relative to the others, are unchanged
14. Monitor considers that paragraph 13b is not met on the grounds that the rights of the ultimate shareholders (PDC stakeholders) are varied. FTs have far greater freedoms than NHS Trusts to operate and to pursue their own business objectives and are largely free from the SoS’s control. These differences are discussed further below.

15.

Area of Control/Influence	NHS Trusts	NHS Foundation Trusts
<b>Constitution</b>	Set out in Establishment Order, which draws on in turn relevant legislation e.g. the 1990 Act, 1977 Act	Section 6 (2) (a) and Schedule 1 of the Act and Terms of Authorisation issued by Monitor  FT may amend its constitution with Monitor's approval.
<b>Power to appoint Chair and non-execs</b>	Appointed by the Secretary of State and the NHS Appointments Commission respectively	The Chair and non-executive directors are appointed by the Board of Governors which in turn are either appointed (for example by PCTs or local authorities) or chosen by election of members.
<b>Powers</b>	Restricted by statute to the provision of healthcare, but in many cases there are requirements to comply with any relevant SoS directions. Very limited powers to invest.	Restricted by statute to the provision of healthcare FTs have quite wide-ranging powers, for example, to invest.
<b>Funding</b>	'NHS contracts' with commissioners which can be - and frequently are - subject to variation through local NHS processes e.g. SHA arbitration.	The Terms of Authorisation require private law contracts with Commissioners. These cannot be varied unilaterally by one party.

Area of Control/Influence	NHS Trusts	NHS Foundation Trusts
<b>Financial controls</b>	<p>Statutory requirement to break-even.</p> <p>Statutory requirement to remain within Capital Resource Limit (CRL) issued by SHA.</p> <p>Statutory requirement to comply with other financial objectives that SoS may set. One such is the requirement not to exceed External Financing Limit (EFL) set by SoS.</p>	<p>Not required to break-even but must be financially viable (as would be the case for any other entity).</p> <p>Subject to a Compliance Framework, which includes the setting of financial risk ratings.</p> <p>Able to borrow from commercial sources within limits set by Monitor, but their capital requirements are not subject to central determination.</p> <p>Potential for statutory intervention by Monitor under the Act.</p>
<b>Public Dividend Capital</b>	Determined by SoS.	Terms of PDC determined by SoS with consent of Treasury and having consulted Monitor.
<b>Accounting regime</b>	NHS Trusts are required to prepare their financial statements in accordance with the NHS Trust Manual for Accounts, and to follow the accounting policies specified therein.	Monitor's FReM requires FTs to prepare their financial statements in accordance with UK GAAP and provides guidance to FTs on its interpretation for the sector. The FReM does not specify financial policies for FTs to follow.

16. The SoS does not appoint the Board of Governors or the Board of Directors of an FT. The SoS's control over FTs is effectively limited. Given the current government policy for all NHS Trusts to become FTs by 2008, it is doubtful as to whether the legislation underlying the FT concept is likely to be repealed in the foreseeable future.
17. In substance therefore, once foundation trusts have been established, they are then broadly able to pursue their own financial and operating policies in accordance with their statutory powers and Monitor's "light touch" regulation. Indeed, this comparative autonomy is fundamental to the FT concept. Monitor's view is that these freedoms provide sufficient separation from the government's control of other bodies, including NHS Trusts. Consequently any business combinations between an FT and an NHS Trust or its underlying business, which results in the

continuation of the FT or the creation of a new FT, should not be considered as a group reconstruction or “Machinery of Government change” as the rights of the shareholders (PDC stakeholders) are varied. Merger accounting therefore should not be applied.

### **PDC transfer between NHS Trusts and FTs**

18. Were merger accounting to be applied, to do so in a meaningful manner would require the PDC and reserves in the combined entity to represent the aggregate of those from the FT and the NHS Trust. However, the DH existing guidance indicates that an NHS Trust’s PDC cannot transfer, is specific to the individual trust and can only be repaid or written-off (for example on dissolution of the Trust). DH is currently seeking legal advice as to whether PDC may transfer between entities, however, their preferred approach is the cancellation / repayment of PDC and issue of new PDC, which is specific to individual entities.
19. Even if PDC can transfer, the guidance further notes that an NHS Trust’s other reserves (including the income and expenditure reserve) cannot be transferred to another entity. The only exception to an NHS Trust’s capital and reserves transferring directly to another body occurs when a new FT is created directly from an NHS Trust through Monitor’s statutory authorisation process.
20. In Monitor’s guidance for applicants on mergers it has noted that it is for the merging parties to agree on the treatment of their closing reserves. If the parties decide not to transfer reserves, or if the DH accounting rules prohibit the transfer of the NHS Trust’s reserves, then it would be difficult to apply merger accounting to the transaction in a meaningful manner.
21. For these reasons Monitor is seeking approval for the application of acquisition accounting to transactions between an NHS Trust and FT. Further where an FT acquires a private sector business Monitor requires FRAB to note the application of acquisition accounting in this scenario.

## **Proposed Accounting for Business Combinations**

### **A A purchase of the business of an NHS Trust by an FT**

22. A scenario currently under discussion in the FT sector is the acquisition by an FT of the underlying business of another NHS Trust. Such an acquisition is expected to involve the FT taking over the assets, liabilities, personnel and services of the NHS Trust in exchange for a payment to the Secretary of State. This payment will be determined by negotiations between the FT and the SoS, reflecting each party’s view of the value of the business, and may be nil or even negative where the underlying business is in deficit. The key distinction between this form of transaction and the one set out in “B” below is that this form of transaction does not use the mechanism set out in ss 27 and 28 of the Act.

#### ***Acquisition accounting***

23. If an FT purchases the entire business of an NHS Trust, as described above, and the substance of the transaction is likely to be that the FT acquired the NHS Trust rather than it being a merger between equals, then the transaction would appear to be in substance that of an acquisition under UK GAAP. For example, where the new entity’s management comprises mostly or wholly the management of the existing FT, then it would be seen as the acquirer and the dominant party, and thus the substance of the transaction may be that of an acquisition.
24. Goodwill would arise to the extent that the purchase consideration differs from the fair value of the net assets acquired. If the transaction is genuinely one of a bargain purchase then negative goodwill will arise.

### ***Merger accounting – practical problems***

25. Merger accounting may be appropriate where the substance of the combination is genuinely that of a merger, but these situations are likely to be very rare. Some form of merger accounting would then need to be applied, but there may be practical difficulties in doing so, for example the PDC and reserves in the combined entity would need to be the aggregate of those from the FT and the NHS Trust. Since DH guidance indicates that the NHS Trust's PDC cannot transfer, however, there will be a 'dangling credit' representing the NHS Trust's PDC balance minus any cash consideration paid by the FT (the FT could probably recognise amounts in its accounts in relation to the NHS Trust's other reserves, but it is unlikely to be able to recognise a PDC balance that did not match the actual PDC issued to it).

### ***Fresh-start accounting***

26. Monitor does not consider that 'fresh-start' accounting is appropriate in this scenario, as one of the parties - the FT - continues in existence.

### **B Mergers between NHS Trusts and FTs using the statutory mechanism under the Act**

27. Where the bodies merge under ss 27 and 28) of the Act, the existing bodies are dissolved and a new Foundation Trust established.

28. As a result of the dissolution, in Monitor's view, 'merger by absorption' accounting should be applied in this scenario as:

- this best reflects the substance of the business combination;
- the bodies' decisions and/or Government Accounting rules in relation to the transfer of Public Dividend Capital (PDC) and other reserves an NHS Trust may preclude alternative treatments (as previously described in paragraph 17, 18 and 19); and
- the entities are not, in Monitor's view, subject to a group reconstruction.

### ***A purchase of a private sector business by an FT***

29. Monitor considers that this combination should be accounted for as an acquisition under FRS 6 and 7.

### **Impact on central government accounts, including WGA**

30. The Department of Health's annual Resource Accounts do not include the activities of FTs or NHS Trusts. The accounts do include PDC transactions between the Department and both FTs and NHS trusts, but these transactions with both types of bodies are aggregated. Monitor understands that the accounting treatments for the transactions should not, therefore, have any impact on the DH resource accounts.

31. The accounting treatment adopted by an FT should not affect the NHS (England) Summarised Accounts, as these do not include FTs. To comply with the merger accounting requirements under the FR&M, the Summarised Accounts would need to treat the NHS Trust operations transferred/acquired as if they had never been part of the Summarised Accounts. This would involve excluding any part-year NHS Trust activities and restating the prior year comparatives to remove the full year activities for those Trusts. A review of the 2004/05 NHS (England) Summarised Accounts reveals that these adjustments have not been made for those FTs created in 2004/5. The prior year comparatives are unchanged, and the reserves note records transfers-out of reserves to FTs both on 1 April 2004 and for in-year transfers. It thus appears that activities of part-year NHS Trusts are included in the Summarised Accounts until the date they become FTs.

32. The accounting policies for Monitor's Summarised Accounts of FTs currently treat newly created FTs as 'activities commenced' by the 'group' during the year. Any activities acquired by non-statutory means are treated as acquired activities within the meaning of FRS 3 and FRS 6. The adoption of fresh-start accounting for transactions that fall into ss27 and 28 of the Act and acquisition or merger accounting for purchases of NHS Trust businesses that do not fall under ss27 and 28 of the Act would therefore be consistent with the accounting treatment in the FT Summarised Accounts, and no adjustments would be required.
33. For the Whole of Government Accounts, the strict application of merger accounting would require some adjustments to be made, although the impact might not be material at that level:
34. For transactions that do not fall under ss27 and 28 of the Act, to convert fresh-start accounting to merger accounting for WGA should require only relatively simple adjustments. The FT Summarised Accounts record the activities of an FT only from the point at which it is created. The use of fresh-start accounting by FTs for statutory mergers would be consistent with this. Similarly, as noted above, the NHS (England) Summarised Accounts record the activities of NHS Trusts up to the point at which they become an FT.
35. Thus if the two sets of Summarised Accounts are consolidated for WGA purposes, the old and new activities will simply aggregate. The adjustments that would then be needed would be for any in-year transfers-out of assets and reserves from the NHS Summarised Accounts to be cancelled against the opening asset and reserve balances of the new FTs. Additional adjustments may be needed where the accounting policies of the two sectors are not aligned, but this is required regardless of which accounting method is chosen.
36. For purchases of NHS Trust businesses that do not use the mechanisms set out in ss27 and 28 of the Act, applying merger accounting for WGA would require removing the acquisition transactions from the FT Summarised Accounts and the disposal transactions from the NHS (England) summarised accounts. All of the information needed to remove these transactions should be readily obtained from the FTs and NHS Trusts in question.

### **UK GAAP compliance**

37. The principles adopted are designed to reflect the underlying substance of the transactions and reflect UK GAAP where applicable.

### **Summary and recommendation**

38. The accounting treatments have been prepared in accordance with the underlying principle that the accounting practices adhere to UK GAAP as far as possible.
39. Monitor requests FRAB to approve the proposed treatments for each of the scenarios in this paper and the guidance to be included in the 2006/07 FT Financial Reporting Manual (FT FReM). The Financial Reporting and Advisory Board are also asked to approve the proposed treatments and the guidance to be included in the FT FReM as set out in Annex 1.

Monitor

24 October 2006

**Text of proposed guidance to be included in the 2006/07 FT FReM**

It is proposed to include the following guidance in the FT FReM with effect from 2006/07.

**Chapter 2**

**Extant accounting standards**

Extract from table in paragraph 2.9:

Accounting standard	FReM reference	Applicability, additional guidance and reference to relevant guidance in this manual	Revisions since 2005/06
<b>Financial Reporting Standards (FRSs)</b>			
6: Acquisitions and mergers	5.4.2-5.4.4	Guidance included on accounting for statutory mergers and for the acquisition of NHS Trust businesses by FTs.	New guidance

**Chapter 3:**

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**“Acquisitions and Mergers**

**Statutory mergers**

Where a new Foundation Trust is created as a result of a merger between an existing FT and another FT and or an NHS Trust under ss27 and 28 of the 2003 Act, fresh-start accounting should be adopted.

The opening balances sheet should simply represent the aggregate of the final assets and liabilities at the point the existing entities demise. Some adjustments will need to be made to the existing balances of the NHS Trust to bring the accounting policies in line with those for FTs, for example, recognising accrued income for part-completed patient spells.

The opening capital and reserves of the new entity should comprise the PDC assigned to the new entity, together with any other reserves determined by Monitor in conjunction with the Secretary of State and notified to the entity.

Prior-year comparatives are not required to be included in the first year’s accounts of the new entity.

**Example**

An FT and an NHS Trust merge on 1/9/06 using the statutory mechanism under ss27 and 28 of the 2003 Act to create a new FT.

	<b>NHS Trust</b>	<b>Foundation Trust</b>	<b>Adjustments for Alignment of Accounting Policies</b>	<b>Foundation Trust</b>
	Balances 31/8/06	Balances 31/8/06		Balances 1/9/06
	£000	£000	£000	£000
<b>FIXED ASSETS:</b>				
Intangible Fixed Assets	15	20		35
Tangible Fixed Assets	30,000	60,000		90,000
<b>CURRENT ASSETS:</b>				
Stocks and WIP	400	500		900
Debtors	6,000	5,500	500 <sup>1</sup>	12,000
Cash at Bank and in hand	5	15		20
<b>CREDITORS:</b>				
Amounts falling due within one year	(7,500)	(3,000)		(10,500)
<b>NET CURRENT ASSETS (LIABILITIES)</b>	<b>(1,095)</b>	<b>3,015</b>		<b>1,920</b>
<b>CREDITORS:</b>				
Amounts falling due after more than one year	0	(2,000)	(400) <sup>2</sup>	(2,400)
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>	<b>(1,000)</b>	<b>(1,500)</b>		<b>(2,500)</b>
<b>TOTAL ASSETS EMPLOYED</b>	<b>27,920</b>	<b>59,535</b>		<b>87,555</b>
PDC	25,000	48,000		87,555
Revaluation Reserve	5,000	6,000		0
Donated Asset Reserve	200	100		0
Government Grant Reserve	400	0	(400) <sup>2</sup>	0
Other Reserves	0	0		0
Income and Expenditure Reserve	(2,680)	5,435		0
<b>TOTAL CAPITAL AND RESERVES</b>	<b>27,920</b>	<b>59,535</b>		<b>87,555</b>

The opening assets and liabilities of the new FT are simply the aggregated amounts from the demising bodies after the adjustments have been made to align the NHS Trust's accounting policies with those of the new FT:

<sup>1</sup> Alignment of NHS Trust balance to accord with FT accounting policy on partially completed patient spells results in the recognition of £500k of accrued income in respect of the NHS Trust

<sup>2</sup> Alignment of NHS Trust balance to accord with FT accounting policy on government grant funded assets, results in the reclassification of the government grant reserve to deferred income balance

The PDC and reserves of the demising bodies are not transferred to the new FT. Instead the new FT is issued with PDC equivalent to its opening net assets (after the accounting policies adjustments).

### **Purchase of the business of an NHS Trust by an FT**

Where a Foundation Trust purchases the business of an NHS Trust, and the latter's management has little or no role in the future operation of the combined entity, the substance of the transaction is likely to be that of an acquisition, and provided the transaction does not use the mechanism set out in ss27 and 28 of the 2003 Act should be accounted for as an acquisition in accordance with FRS 6.

The characteristics of such a transaction are likely to include the FT taking on the assets, liabilities, employees, healthcare and supplier contracts of the NHS Trust, in return for payment of consideration to the Secretary of State. That such consideration may be nil or even negative, would not preclude the use of acquisition accounting.

Where an FT purchases the business of an NHS Trust and the commercial substance is one of a merger for accounting purposes, then, provided the transaction does not use the mechanism set out in ss27 and 28 of the 2003 Act, it should be accounted for using merger accounting. However, such scenarios will be very rare. Furthermore, there are likely to be significant practical problems in applying merger accounting in these circumstances, for example in relation to the treatment of reserves.

Where an FT acquires only the fixed, or other, assets of an NHS Trust, and no other aspects of its activities, such a transaction should normally be accounted for as the purchase of assets.

### ***Fair value exercise (FRS 7)***

FRS 7 requires that the fair value of the assets and liabilities must be determined and brought into the acquiring body's accounts at these values. The standard sets out the basis for determining the values of assets and liabilities, which FTs should follow.

The standard also requires adjustments, where necessary, to include assets or liabilities not recognised in the acquired entity's financial statements, and similarly to exclude certain assets and liabilities from the overall valuation. FTs should apply the standard's requirements to determine whether such adjustments are necessary. Monitor considers that the following adjustments are most likely to be applicable:

- The inclusion of **contingent assets** where the inflow of economic benefits is probable (under FRS 12 these would only be permitted once the inflow is virtually certain) – this situation might arise where the NHS Trust has an arbitration dispute over contract income with a purchaser.
- The inclusion of **contingent liabilities** where the outflow of economic benefits is probable but where not provision has been made in the acquiree's accounts due to lack of reliable measurement – for

example legal cases. The standard permits 'best estimates' to be used, and they can be declared as provisional and adjusted after once better information becomes available.

- Adjustments to bring the NHS Trust's **accounting policies** in line with the FT's – for example:
  - including partially-completed patient spells; and
  - re-classifying any government grant reserve as a liability.

The standard also requires that assets and liabilities arising from the acquirer's intentions should not be included in the fair value of the net assets, for example provisions for impairment, future operating losses and reorganisation and integration costs.

### **Goodwill**

Goodwill represents the difference between the fair value of the net assets acquired and the purchase consideration. Where an FT acquires the NHS Trust's business in a bargain purchase, then negative goodwill is likely to arise.

Where negative goodwill arises, FTs should carefully consider whether the assets and liabilities are appropriately valued and not in need of adjustment, for example impairment of fixed assets.

Furthermore, FRS 6 prohibits the recognition of both negative goodwill and intangible assets, for example software licences, in the same transaction. Any intangible assets should therefore be de-recognised from the fair value of net assets until negative goodwill is either eliminated or is minimised (by the intangible assets being de-recognised in full).

Any remaining negative goodwill should be shown on the face of the balance sheet as a separate intangible fixed asset. To the extent that it can be matched with non-monetary assets (for example, tangible fixed assets, stock), it should be released to the Income and Expenditure account in line with the charging of those costs to that account. Any negative goodwill in excess of the fair value of non-monetary assets should be recognised in the I&E account in the periods expected to be benefited.

Where the transaction results in the recognition of positive goodwill, this should be accounted for in accordance with FRS 6.

### **Example**

An FT acquires the entire business of an NHS Trust on 1/9/06 in return for cash consideration of £25.5m paid by the FT to the Trust and the transaction does not use the mechanism set out in ss27 and 28 of the 2003 Act:

	<b>NHS Trust</b>	<b>Fair Value Adjustments</b>	<b>NHS Foundation Trust</b>	<b>NHS Foundation Trust</b>
	Balances 31/8/06 £000	£000	Balances 31/8/06 £000	Balances 1/9/06 £000
<b>FIXED ASSETS:</b>				
Intangible Fixed Assets	15	(15) <sup>3</sup>	20	20
Negative Goodwill				(2,505)
Tangible Fixed Assets	30,000		60,000	90,000
<b>CURRENT ASSETS:</b>				
Stocks and WIP	400		500	900
Debtors	6,000	500 <sup>1</sup>	5,500	12,000
Cash at Bank and in hand	5		2,500	505 <sup>4</sup>
<b>CREDITORS:</b>				
Amounts falling due within one year	(7,500)		(3,000)	(10,500)
<b>NET CURRENT ASSETS (LIABILITIES)</b>	<b>(1,095)</b>		<b>5,500</b>	<b>2,905</b>
<b>CREDITORS:</b>				
Amounts falling due after more than one year	0	(400) <sup>2</sup>	(2,000)	(2,400)
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>	<b>(1,000)</b>		<b>(1,500)</b>	<b>(2,500)</b>
<b>TOTAL ASSETS EMPLOYED</b>	<b>27,920</b>		<b>62,020</b>	<b>85,520</b>
PDC	25,000 <sup>6</sup>		48,000	71,500 <sup>5</sup>
Revaluation Reserve	5,000 <sup>6</sup>		6,000	6,000
Donated Asset Reserve	200 <sup>6</sup>		100	100
Government Grant Reserve	400	(400) <sup>2</sup>	0	0
Other Reserves	0 <sup>6</sup>		0	0
Income and Expenditure Reserve	(2,680) <sup>6</sup>		7,920	7,920
<b>TOTAL CAPITAL AND RESERVES</b>	<b>27,920 <sup>6</sup></b>		<b>62,020</b>	<b>85,520</b>

## FAIR VALUE ADJUSTMENTS

<sup>1</sup> Alignment of accounting policy on partially completed patient spells results in the recognition of £500k of accrued income in respect of the NHS Trust

<sup>2</sup> Alignment of accounting policy on government grant funded assets, results in the reclassification of the government grant reserve to deferred income balance

	£000
<b>Capital and Reserves:</b>	27,920
<b>Adjustments:</b>	
<b>1</b>	500
<b>2</b>	(400)
<b>Adjusted Capital &amp; Reserves:</b>	28,020

## CALCULATION OF GOODWILL

The Foundation Trust has paid cash consideration to the NHS Trust of £25.5m. It has financed this by drawing on its cash reserves for £2m and by an additional PDC allocation of £23.5m.

	£000
Fair Value of purchase consideration	25,500
<b>Less:</b>	
Adjusted Fair Value of Net Assets acquired	28,020
	(2,520)
(Negative) Goodwill	(2,520)

However Intangible assets and negative goodwill cannot be recognised in the same transaction. The intangible asset balance must therefore been reduced to minimise the negative goodwill as far as possible.

Intangible asset removal: <sup>3</sup>	15
<b>Adjusted negative goodwill</b>	<b>(2,505)</b>

## OTHER ADJUSTMENTS

<sup>4</sup> Cash balance comprises the existing balances less the £2m used by the FT in the purchase

<sup>5</sup> PDC balance comprises the FT's existing balance plus the £23.5m allocation received for use in the purchase

<sup>6</sup> The PDC and Reserves of the NHS Trust are not brought into the accounts of the FT

### ***Date of acquisition***

The FT needs to determine the date from which the acquired NHS Trust's business should be recognised in its accounts. This may not necessarily be the date on which the transaction occurs or is completed, but is instead the date on which the FT gains the power to control the activities of the NHS Trust, as recognised by the point at which it becomes a subsidiary undertaking within the meaning of FRS 2.

If, for example, the actual transaction is preceded by a period in which the FT has some influence or control over those activities, it will be necessary to consider these arrangements against the FRS 2 criteria to determine the point at which the FT, in substance, acquires those activities. It should be noted that the FRS 2 criteria are not intended to be interpreted restrictively."

## **Appendix A to chapter 3: Example accounting policies**

### **"Acquisitions and discontinued operations**

....

Activities are considered to be 'acquired' whether or not they are acquired from outside the public sector.

[Insert]:

Acquired activities are accounted for as acquisitions in accordance with FRS 6. The fair value of identifiable assets and liabilities are determined in accordance with FRS 7 and are included in the Trust's accounts at the date of acquisition. The results and cash flows of the acquired activities are included in the Trust's accounts only from the date of acquisition."

## **“Goodwill**

Goodwill is recognised at the date of acquisition, as the difference between the fair value of the identifiable net assets acquired and the fair value of the purchase consideration.

Positive goodwill is capitalised and recognised as an intangible asset on the balance sheet. It is amortised to the Income and Expenditure account on a straight-line basis [or another basis if more appropriate], over its useful economic life, which is reviewed at the end of each financial year. The carrying value is subject to an impairment review at the end of the first full financial year following acquisition, and in other years if events or circumstances indicate that the carrying value may not be recoverable. [Or, exceptionally, if the UEL is more than 20 years: “The carrying value is subject to an annual impairment review.”]

Negative goodwill is recognised as a negative intangible asset on the balance sheet. Negative goodwill up to the value of the non-monetary assets acquired in the transaction is recognised in the income and expenditure account in the periods in which the non-monetary assets are recovered. Negative goodwill in excess of the value of the non-monetary assets acquired in the transaction is recognised in the income and expenditure account in the periods expected to be benefited.”

**[NB** due to its nature no accounting policy is required for ‘merger by absorption’]