1 ACCOUNTING FOR AMALGAMATIONS AND CORPORATE RESTRUCTURING

Topic 1 : Amalgamation of Companies

Preamble

The term “amalgam” means to unite, to come together as one, or to blend, and, from this root, the accounting terminology of ‘Amalgamations’ is derived. The popular meaning of “amalgamation” is the dissolution of one or more companies and transfer of business of dissolved entities to another entity. Companies and business entities come together to form a single entity for various reasons, including but not limited to the objective of effecting tax savings. It is essential to be well versed with the accounting treatment to be accorded for such transactions.

Scope

What is taken care of by AS 14 is an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute, which may be applicable to companies. In a number of UK (also Indian) cases, the Courts have decided that this terminology includes 'absorption' as well. The popular meaning of “absorption” is the acquisition of a business by an existing company. Consider the position in the following table.

Amalgamation (does not cover acquisition)	***Absorption***
• Status of a separate legal entity of two or more entities vanishes – a new entity emerges	• Status of a separate legal entity of one or more entity vanishes – one existing entity takes over
• If X Ltd. and Y Ltd. are liquidated and a newly formed Company Z Ltd. acquires the two businesses, it is termed as amalgamation.	• If X Ltd. is taken over by Y Ltd. it is referred to as 'absorption'. Here there is no formation of a new entity, but there are one or more liquidations.
• X Ltd. and Y Ltd. are transferors, Z Ltd. is transferee	• X Ltd. is transferor; Y Ltd. is transferee

It is safe to assume that the connotation of the term amalgamation also include absorption.

Coverage under AS 14 excluded

There are circumstances in which one company can obtain control over another, without impinging upon the status of each company being an independent and separate “legal entity”, and yet deriving the benefit of “coming together” by acting as one single “economic entity”. Accounting treatment for such situations is covered by the pronouncements under AS 21 – Consolidated Financial Statements.

Important terms - defined

- *'Transferor Company'* means a company, which is amalgamated into another company. The company selling its business is also called "**Vendor Company**".
- The company into which a transferor company is amalgamated is called the *"Transferee Company"*. The Company which acquires (or buys) the business is also called the "**Vendee Company**".

Business entities coming together

Generally speaking, there are two basic "methods" in which business entities unite together. In this backdrop, the Standard brings the concept of amalgamation under two broad heads (Merging or Purchasing).

a. First is **'amalgamation in the nature of merger'**. Under this category, there is a genuine pooling

⇒ not merely of the assets and liabilities of the amalgamating companies

⇒ but also of the interests of shareholders and of the business of these companies.

b. Second is **'amalgamation in the nature of purchase'**. Transactions under this category are in effect

⇒ a mode by which one company acquires another company, and

⇒ as a consequence, the shareholders of the company which is acquired normally do not continue to possess interest in the equity of the combined company in an identical proportion, to that held by them in the liquidated company. Also the business of the company, which is acquired, is not necessarily intended to be continued.

Amalgamation in the nature of merger

What distinguishes a "merger" from a "purchase", is the true substance of the transaction. It is helpful to know that the UK-Financial Reporting Standard 6 deals with "merger". Relevant excerpt from FRS 6 is furnished below

> ***"Merger is a business combination which results in the creation of a new reporting entity formed from the combining parties, in which the shareholders come together in a substantially equal partnership for the mutual sharing of risks and benefits of the combined entity; and in which no party to the combination, in substance, obtains control over any other.. .. .. .."***

AS 14 enumerates five specific conditions, on fulfillment of which the event of two entities coming together is to be treated as "amalgamation in the nature of merger".

Five Conditions

- **All the assets and liabilities** of the transferor company (for brevity referred to as SC) become the assets and liabilities of the transferee company (for brevity referred to as PC)
- Shareholders of SC holding **not less than 90% of the "face value" of equity shares** become the shareholders of PC by virtue of amalgamation. For the purpose of computing 90%, exclude shares already held prior to amalgamation, by:

  ⇒ PC in the SC
  ⇒One or more subsidiaries of PC in the SC, and
  ⇒Nominees of PC in the SC
- The **consideration** paid to equity shareholders of the SC is **in the form of equity shares** in the PC, except that cash may be paid in respect of any fractional shares.
- The **business of the SC** is intended to be carried on, after the amalgamation, by the PC, and
- Assets and liabilities of SC are incorporated in the financial statements of the PC at **book values** except to ensure uniform accounting policies. Thus, if SC is following straight-line method of depreciation and the PC is following written down value method, the book value of the assets of SC will be revised by applying written down value method. This would ensure adoption of uniform accounting policy for the pooled assets.

Consider the following example of A Ltd., and B Ltd., who come together by forming AB Ltd. Consideration is paid by way of shares in AB Ltd.

₹ in Lakhs

Particulars	***A Ltd***	***B Ltd***
Share capital	100	150
Retained earnings	80	120
Loans, creditors and payables	115	110
Total liabilities	***295***	***380***
Fixed assets	175	260
Current assets including bank balance	120	120
Total assets	***295***	***380***

Assume that AB Ltd. issues shares for ₹250 of which 2/5th will go to A Ltd., and 3/5th will go to B Ltd. The balance sheet of AB Ltd. will emerge as under.

₹ in Lakhs

Particulars	***AB Ltd***
Share capital	250
Reserves	200
Loans, creditors and payables	225
Total liabilities	***675***
Fixed assets	435
Current assets including bank balance	240
Total assets	***675***

[Note: In practice, however, the mergers would be a much more complex affair than the much-simplified version presented as example].

Amalgamation in the nature of purchase

What is not a merger, is a purchase.

If any one or more conditions pertaining to 'merger' listed in the earlier paragraph are not satisfied, then it is a case of amalgamation in the nature of purchase. *Even if one condition of merger is not satisfied, it amounts to purchase*.

Method of Accounting

Nature of Amalgamation	***Method of Accounting***
Merger	Pooling of Interest method
Purchase	Purchase Method

Pooling of Interest method

There are three salient features:

1. In preparing financial statements of PC, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the SC should be recorded at their existing carrying amounts and in the same form as at the date of amalgamation. The balance of the profit and loss account of the SC should be aggregated with the corresponding balance of PC or transferred to *'General Reserve'*, if any.

   Note : The "Expert Advisory Committee" have given an opinion that if the consideration is less than the paid up capital of the transferor company, the difference is to be treated as "*capital reserve*" since it is more in the nature of share premium. Such capital reserve will neither be eligible for dividend nor declaration of bonus.[Refer Problem 4]

2. If at the time of amalgamation, the transferor and transferee companies were to have accounting policies that are conflicting, such conflict is resolved, and brought in line with the policy adopted by PC. A *uniform set of accounting policies should be adopted* following the amalgamation. The effect of any changes in the accounting policies on the financial statements should be reported in accordance with AS-5.

3. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of the share capital of the SC should be adjusted in reserves. Accordingly*, no goodwill or capital reserve,* will arise out of amalgamation by way of merger. Courts may nevertheless stipulate (in some circumstances), the manner in which reserves should be adjusted or reported. This should be followed.

Purchase Method

The object of purchase method is to account for amalgamation by applying the same principles as are applied in any normal transaction involving purchase of assets. Accordingly, the following rules are adopted in this method.

1. The assets and liabilities (but not the reserves) of SC are incorporated in the financial statements of PC at existing carrying amounts. Alternatively, the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their *fair values* at the date of amalgamation. *Fair value is defined in AS 14 in the same way as defined under AS 13.*

2. Identity of *non-statutory reserves* (whether capital or revenue or arising on revaluation) of the SC is not preserved, and hence such reserves are *not to be included* in the financial statement of the PC.

3. If the purchase consideration is more than the net assets, the difference should be debited to *goodwill account*. Conversely, if the value of net assets is more than purchase consideration, the difference should be credited to *capital reserve account.*

4. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

5. Where the requirements of relevant statute so demand, "Statutory reserves" of SC should be recorded in the financial statements of the PC. While crediting the statutory reserve, debit is given to **'Amalgamation Adjustment Account.'** This account should be disclosed in the balance sheet under the category '*Miscellaneous Expenditure'* or other similar category. When the legal requirement no longer warrants maintenance of such a reserve, a reversal entry is passed debiting the statutory reserve and crediting the 'Amalgamation Adjustment Account'.

The important differences between the two methods of accounting are summarised below:

Particulars	***Pooling of Interest***	***Purchase***
Discharge of purchase consideration	Mainly shares; cash for settling dues of fractional shares	Shares, or other securities, or cash
Assets and Liabilities	Recorded at book values	Recorded at Fair values
Reserves	Are brought into and recorded in the books	Only statutory reserves are recorded by debit to Amalgamation adjustment account (reversed when statutory conditions are met)
Difference between consideration and net value of assets	Not recorded – difference is adjusted against reserves	Recorded as goodwill or capital reserve

Three areas having linkage

a) Non-cash consideration

Consideration for any transaction may partly or solely comprise "non-cash" element. (AS 10 and AS 13 also touch upon this aspect). In a purchase or merger, consideration paid to SC may include securities or other non-cash elements. Four aspects have to be kept in mind.

- Such non-cash component must be valued at *fair value*.
- If securities are issued, value fixed by the statutory authorities may be taken to be the *fair value.*
- If other assets are handed over, *fair value* may be determined by reference to the market value of assets given up.
- Where *market value* of assets given up *cannot be reliably assessed*, such assets may be valued at their respective *net book values*.

b) Adjustment of consideration – Future events

It is possible that a purchase or merger transaction is concluded on terms and conditions, that may include an element of consideration payable on a subsequent date, and conditional upon one or more future uncertain events materialising. Two possibilities can emerge:

- Such a conditional payment is probable, and amount can also be estimated. If affirmative, include the amount in the consideration.
- In all other cases, adjustment should be recognised as soon as the amount is determinable.

Consider the following example.

Situation	***Alternative I***	***Alternative II***
Conditional payment	₹10 Lakhs + 1% on sales for each of three following complete financial years	₹10 Lakhs + 1% on sales for each of three following complete financial years, minimum ₹1 lac per annum
Aspects enquired into	1% on future sales not determinable	1% on future sales not determinable – but minimum amount determinable
Action	No need to include additional consideration at the time of purchase	Include additional consideration of ₹3 Lakhs at the time of purchase

c) Treatment of reserves specified in the scheme of amalgamation

Company Law related issue (Refer Section 394(b)(vi) of 1956 Act)

In a scheme of amalgamation, court approval is obtained at times. In such an event, the court is empowered to prescribe conditions to ensure that the scheme is fully and effectively carried out. The order may include conditions pertaining to "treatment of reserves" of SC after amalgamation. The Standard provides that if there is any such condition attached to the scheme, the treatment so prescribed should be followed.

In some cases, where the "court approved" terms enable an entity to treat "reserves" in a manner different from those laid down under AS 14, further disclosures should be made as under:

a) Description of accounting treatment given to reserves

b) Reason for following a treatment that differs from AS 14

c) Deviations in the accounting treatment given to reserves as prescribed by the scheme of amalgamation, sanctioned under the statute, as compared to the requirements of AS 14 that would have been followed, had no treatment been prescribed by the (court approved) scheme.

Disclosure Requirements

Prescriptions in the Standard cover three distinct areas:

For all Amalgamations

- Names, general nature of business of amalgamating companies, effective date
- Method of accounting
- Particulars of scheme – statutorily sanctioned
- *Amalgamation after B/S date (before issue of financial statements) disclose as per AS 4 – BUT NOT TO BE INCORPORATED IN FINANCIAL STATEMENTS*

For Pooling of interest – 1st Financial Statement

- Description and Number of shares issued
- % of equity shares exchanged to give effect to amalgamation
- Difference between consideration and NAV; treatment thereof

For Purchase method – 1st Financial Statement

- Consideration paid and contingently payable
- Difference between consideration and NAV; treatment thereof
- Amortisation period of goodwill (if any)

Amalgamation after Balance sheet date

The possibility of an amalgamation arrangement being concluded after balance sheet date (but before issue of financial statement) cannot be ruled out. Keeping this in view, the Standard provides two alert signals: