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2 December 2016

Dear Sirs

Post-implementation Review of Accounting Guideline 5
Merger Accounting for Common Control Combinations

KPMG in Hong Kong appreciates the opportunity to comment on the Institute's Request for Information (RFI) mentioned above.

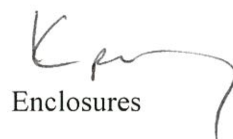
To summarise our overall implementation experience with Accounting Guideline 5 (AG5), it has been working as intended, meeting the information needs of users and regulators, without creating any major implementation challenges for preparers. Since its issuance in 2005, the guideline has been providing practical accounting guidance on common control combinations, helping to enhance consistency on the accounting, presentation and disclosures of common control combinations. Specifically, it provides a common reference point for preparers, users and regulators like on "how to" merger account, a critical area of accounting where IFRS or HKFRS are otherwise silent.

The appendix to this letter sets out our detailed response to the questions raised in the RFI, setting out our basis for this observation.

We would urge the Institute to share the implementation experience in Hong Kong with the International Accounting Standards Board (IASB) with respect to its 'business combinations under common control' project and work closely with the IASB to deal with the wider issues around the accounting for common control combinations, of which AG5 only addresses a very narrow aspect. These other issues, together with the related matter of transactions involving newly incorporated companies (sometimes called 'newcos' in practice), include the scope of common control combinations, accounting in separate financial statements, the accounting in the books of the transferor, and when acquisition accounting or merger accounting is the more appropriate.

We trust that the above is clear but, if you require any clarification of our comments and suggestions, please do not hesitate to contact Jim Tang on +852 2685 7610 or Jessica Cheong on +852 2685 7399.

Yours faithfully



Enclosures

KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

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Appendix: Responses to questions raised in the Request for information on Post-implementation review of Accounting Guideline 5

Question 1: Your background and experience

Please tell us about your role with respect to financial reporting (for example, preparer of financial statements, auditor, valuation specialist, user of financial statements and the type of user, regulator, academic, accounting professional body, etc) and your experience with accounting for common control combinations.

KPMG has extensive experience in auditing and advising clients with common control combinations. Our comments in this appendix sets out our general observations through our involvements in these transactions.

Question 2: Scope and authority of AG5

(a) What are the nature and purpose of the common control combination transactions that you encountered? What accounting method (for example, acquisition accounting under IFRS/HKFRS 3 or merger accounting) have you elected to use for these transactions? Why was that method elected?

Common control combination transactions are conducted by listed or unlisted entities for a wide variety of reasons. In our experience, there are three broad types of common control combinations that are commonly seen:

- Type I: These are usually performed by an entity to rationalise the group structure in anticipation for a future sale/IPO. Financial statements users include potential investors who focus on performance trends in the comparative and current periods presented;

- Type II: These are usually performed by an entity to reorganise business lines to improve operational and management efficiency. Financial statements users are usually internal management at different levels whose focus may differ depending on the level their companies are in the group; and

- Type III: These are carried out by a listed entity to expand through acquiring new business from its unlisted parent. Financial statements users include existing and potential investors who focus on the value of the incoming business and its impact on the existing group.

Both acquisition accounting in accordance with IFRS/HKFRS 3 and merger accounting are seen in practice when accounting for common control combination transactions. The accounting method used normally depends on the nature of the specific transaction, the purpose of the financial statements in which the transaction is reflected, the entity's accounting policy for such transactions in general, and in some cases the costs and benefits of the alternative methods. For example:

- Financial statements that are prepared with a heavier focus on a combined entity's historical trends, such as type I combinations as mentioned above, tend to use merger accounting more often.

- Financial statements that are prepared with a heavier focus on the fair value of the acquired business, such as type III combinations discussed above, which has been conducted on the normal commercial terms, tend to use acquisition accounting more often.

(b) If merger accounting was applied to account for common control combinations, did you apply AG5? Please explain why or why not.

In our experience, HKFRS reporters typically adopt AG5 as it sets out the best practice in Hong Kong when merger accounting is applied, and paragraph 35 of the Preface to HKFRSs states that Accounting Guidelines issued by the Institute should normally be followed.

As there are no IFRSs that specifically provide guidance on common control combinations, it is also common for IFRS reporters that are listed or are preparing for a listing in Hong Kong to follow AG5 as a matter of best practice, by applying accounting policy hierarchy in IAS 8, although some of these entities may not apply all the relevant guidance in AG5 in full.

For those companies which do not adopt AG5 in full, the common departures include non-restatement of the comparatives (as financial statements users may be more interested in the future results than historical trends, and restating comparatives are costly), as well as not applying the controlling party perspective and instead measure the assets, liabilities and non-controlling interests (NCI) of the combining businesses using the carrying value of the transferred entity (in case where the changes in NCI during the periods presented are seen as distorting the earning per shares (EPS) trend and making comparison difficult).

Question 3: Applying principles of AG5: Controlling party and carrying values

(a) Appendix 1 of this RfI outlines the principles and procedures for merger accounting, as extracted from paragraphs 4 to 13 of AG5. Are these principles and procedures clear? If not, what is unclear or missing? Please specify the reasons behind your answer.

We consider the principles and procedures for merger accounting in AG5 – in particular the 'controlling party perspective' and restatement of comparatives – are clear.

As is explained in (b) below, we observe that there could be judgement in deciding on the identity of the 'controlling party' when there are more than one of these. However, we do not believe these reflect the lack of clarity of the AG5 guidance; rather we believe these reflect the wide variety of common control combinations in practice and the need to keep AG5 principles-based as far as possible so entities are allowed room to judge how to apply AG5 in a way that best reflects their individual circumstances.

(b) What are the main challenges in applying the principles and procedures in paragraphs 4 to 13 of AG5? Please explain why it is challenging and how you have dealt with those challenges.

When there are more than one possible common controlling parties (e.g. either UP or IP in Illustration 1), AG5 does not dictate the determination of the controlling party for the purposes of determining the carrying amounts of the assets, liabilities and NCI of the combining businesses and in practice entities make judgement in making such determination on the basis of their individual circumstances.

On the one hand, we have seen entities taking a more rigid approach of identifying the 'controlling party' as the highest entity within the group that controls all the combining businesses throughout the periods presented, although this approach could be difficult to apply when, for example, that highest entity did not previously prepare consolidated financial statements (e.g. an individual or a corporate that need not present consolidated financial statements).

On the other hand, we have also seen entities taking a more 'facts-and-circumstances' approach making a more holistic assessment of the nature of the specific transaction, the purpose of the financial statements in which the transaction is reflected and the costs and benefits of picking one controlling party over the others, as set out in (c) below.

(c) Using Illustration 1, which entity have you identified as the 'controlling party' when applying AG5 in the consolidated financial statements of P3, and what were the considerations that led you to this determination?

For example, please specify whether your considerations included understanding the: (i) purpose of the financial statements; (ii) underlying nature and economic substance of the transaction; (iii) changes in the common controlling party during the periods presented (if any); (iv) cost considerations (if any); (v) whether the transferred entity was previously purchased from a third party (that is, goodwill was recognized when the acquired entity entered the group); and/or (vi) any other considerations.

In our experience, in particular when an entity applies the 'facts-and-circumstances' approach as set out in our response to (b) above, there is no single determining factor that dictates whether UP or IP should be the controlling party for the purposes of AG5. As shown in the following scenarios, different conclusions on the controlling party can be reached based on the same fact pattern assuming there are different considerations and focuses of both financial statements users and preparers.

Scenario 1: Type I combination, where the focus on presenting comparable historical trend information shapes the judgement when there was a change in the common controlling party during the periods presented

Assume that:
(a) P3 is an IPO candidate,
(b) P3 is preparing financial statements for the purposes of its listing prospectus covering years 1 to 3 and
(c) UP acquired IP at the end of year 2 while IP/P2 acquired S2 before year 1.

P3 considers the identification of **IP** as the controlling party would better achieve its objectives to provide comparable historical financial information to potential investors in a way to also satisfy the stock exchange requirements for presenting results for the track record period (being years 1 to 3). The alternative of UP as the controlling party would result in the omission of results for years 1 and 2 from the track record period, as UP did not control the listing group during that period.

Scenario 2: Type III combination, where the focus on value of the incoming business shapes the judgement when a different parent would attribute a different value to the business as the parents acquired the business at a different time

Assume that:
(a) P3 is listed in Hong Kong and is preparing proforma financial information reflecting its acquisition of S2,
(b) IP/P2 acquired S2 many years ago, while UP acquired IP last year and applied acquisition accounting for that acquisition and
(c) major assets of S2 are intangible assets whose carrying amounts have been minimal from the perspectives of the consolidated financial statements of IP/P2 but are significant from the perspectives of UP.

P3 considers the identification of **UP** as the controlling party would better achieve its objectives. In making this determination, P3 gives more weight to reflecting the financial impact of the acquisition of S2 prospective from the acquisition date as opposed to the historical results of S2 before the acquisition date. P3 considers that identifying UP as the controlling party would better capture the value of intangible assets and any goodwill inherent in S2's businesses and could also promote management accountability for recovering that investment than an alternative identification, without

the need to perform another extensive fair value exercise under the acquisition method on the date P3 acquires S2.

Scenario 3: Type II combination, where there is an increased emphasis on costs-benefits consideration given limited financial statements users

Assume that:
(a) UP is an individual and
(b) previously only IP prepared consolidated financial statements.

P3 considers the identification of **IP** as the controlling party would better achieve its objectives. In making this determination, P3 considers the fact that consolidated financial information is more readily available at the IP than at the UP level, and the additional costs required to establish the carrying value of S2 at the UP level do not out-weigh the resulting benefits.

Scenario 4: Type I combination, where there is scope for reconciling the dual objectives of presenting comparable historical trend information and presenting information that is more consistent with the post-transaction group structure

Assume that:
(a) P3 is an IPO candidate,
(b) P3 is preparing financial statements for the purposes of its listing prospectus, and
(c) UP only holds 80% of IP instead of 100% while all other shareholdings have been 100% throughout.

P3 considers the identification of **IP** as the controlling party would better achieve its objectives. In the absence of other compelling factors to the contrary, P3 regards the consequences of identifying UP as the controlling party, which would result in the presentation of NCI in S2 and the related allocation of S2's results to NCI before P3 actually acquired S2, would be inferior to the alternative. P3 considers that the identification of IP as the controlling party, the consequences of which would be that no NCI would have been presented throughout, provides more comparable historical results consistent with the fact that P3 acquires 100% of S2.

(d) What are the main challenges in accounting for a common control combination using the existing book values from the controlling party's perspective? Please explain why it is challenging and how you have dealt with those challenges.

See our response to (b) and (c) above.

(e) Using Illustration 1, does the possible diversity in identifying the 'controlling party' impair your understanding of P3's consolidated financial statements? If so, please specify how.

In our view, the potential diversity in identifying the controlling party does not necessarily impair users' understanding of P3's consolidated financial statements, so long as any significant judgement exercised in that regard and its effects have been adequately disclosed in accordance with paragraphs 16 to 18 of AG5 and the more general requirement in paragraph 122 of HKAS 1 *Presentation of Financial Statements*. As we also noted in our response to (a) above, the diversity can simply be a reflection of the wide variety of common control combinations in practice.

Question 4: Applying principles of AG5: Minority interests

(a) Is the accounting for minority interests clear in the principles and example of AG5? If not, what do you think is unclear or missing? Please specify the reasons behind your answer.

We consider the AG5 principles on the accounting for minority interests are clear, and the example has adequately illustrated the application of these principles.

(b) What are the main challenges in accounting for minority interests in a common control combination under AG5? Please explain why it is challenging and how you have dealt with those challenges.

As noted in paragraph 10 of AG5, the accounting for minority interests follows the identification of the controlling party. As such, we believe that the implementation issues in relation to the accounting for minority interests flows from those in relation to the identification of the controlling party, as we have addressed in our response to question 3 above.

(c) Using Illustration 2, and assuming that the common control combination had taken place in the current year, please specify how you have recorded the minority interests for entity S2 in the:
(i) consolidated balance sheet of entity P3 as at the current and prior year end dates; and
(ii) consolidated income statement of entity P3, i.e. profit attributable to the minority interests, for the current and prior years.

What were the considerations that led you to this determination? Do you generally consider the level of controlling party when accounting for minority interests in common control combinations?

In order to determine the amount of minority interests, one first has to identify the controlling party for the purposes of applying paragraph 10 of AG5. In Illustration 2, either UP or IP may be identified as the controlling party.

In the illustrations that follow, we have assumed that the acquisition of S2 by P3 took place at the beginning of year 3, and S2's profit for the year in and net assets at the end of years 1 to 3 are as follows:

Year	Net assets	Net profit for the year
1	$800	$100
2	$900	$100
3	$1,000	$100

If IP is the controlling party

If IP is identified as the controlling party, then the net assets and profit for the year shared by the minority interest of S2 in P3's consolidated financial statements at the end of years 1 to 3 will be as follows:

Year	Net assets attributable to minority interest	Profit for the year attributable to minority interest
1	$152 ($800*19%)	$19 ($100*19%)
2	$171 ($900*19%)	$19 ($100*19%)
3	$0 (S2 became a wholly-owned subsidiary of P3 after the common control combination)	$0

If UP is the controlling party

Alternatively, if UP is identified as the controlling party, then the net assets and profit for the year shared by the minority interest of S2 in P3's consolidated financial statements at the end of years 1 to 3 will be as follows:

Year	Net assets attributable to minority interest	Profit for the year attributable to minority interest
1	$56 ($800*7%)	$7 ($100*7%)
2	$63 ($900*7%)	$7 ($100*7%)
3	$0 (S2 became a wholly-owned subsidiary of P3 after the common control combination)	$0

(d) Using Illustration 2, and assuming that the common control combination had taken place in the current year, does the possible diversity in determining the minority interest impair your understanding of P3's consolidated financial statements? If so, please specify how.

For the same reasons set out in our response to question 3(e) above, the potential diversity in determining the minority interest in our view does not necessarily impair users' understanding of P3's consolidated financial statements.

Question 5: Applying principles of AG5: Comparatives

What are the main challenges in presenting the financial statements under the merger accounting principle, which assumes that no acquisition has occurred and that there has been a continuation of the risks and benefits to the controlling party? Please explain why it is challenging and how you have dealt with those challenges.

AG5 requires restating the comparatives as if the entities or businesses had been combined at the previous balance sheet date unless the combining entities or businesses first came under common control at a later date.

Generally, we believe that restating the comparatives is consistent with the principles underlying merger accounting which assumes that the combined entity had been in existence since they became under common control. Accordingly, when the purpose of preparing the financial statements that reflect common control combinations is consistent with these principles, for example in case of type I or type II combinations and users are interested in the historical performance of the combined entities, we are not aware of any specific concerns or challenges in relation to restating comparatives.

However, where financial information is prepared to analyse the future prospects of the combined entities or businesses, such as in case of type III combinations, users may be more interested in the future results than historical trends, and preparers may consider the costs spent on restating the comparatives of the combined entities could outweigh the benefits.

Question 6: Accounting for the consideration paid

(a) In the common control combinations that you have encountered, what forms of consideration are paid for the acquired entity – is it cash, shares, a combination of cash and shares, contingent consideration, or other forms of consideration?

In our experience, common forms of consideration in common control combinations include cash, shares or a combination of both. Contingent consideration is also seen in common control combinations negotiated on an arm's length basis but is less common in combinations with nominal or arbitrary consideration.

(b) The example in AG5 illustrates that the consolidated financial statements of the comparative year are restated as if shares were issued in the comparative year following the principle of merger accounting. If you have encountered forms of consideration other than shares, how have you accounted for it in the current and comparative years?

In our experience, entities typically only recognise the liability for cash consideration when the acquirer has a contractual obligation to settle the consideration, which is normally the time when the common control combination becomes unconditional. Before the acquisition date, no liability is recognised and no adjustment is made to the prior period cash balances.

Under AG5, the consolidated financial statements are presented as if the combination had occurred from the date when the combining entities or businesses first came under the control of the controlling party. As such, comparatives are restated to recognise assets acquired and liabilities assumed by the acquirer at their carrying values in the controlling party's consolidated financial statements. As no cash or consideration payable is recognised before the acquisition date, entities normally recognise the corresponding balancing entry directly in equity.

On the acquisition date, the acquirer recognises the consideration payable with a corresponding adjustment in equity.

Question 7: Applying principles of AG5: Disclosures

(a) What are the main challenges in preparing, auditing or enforcing the disclosures required by AG5 (paragraphs 7(a) to 7(h) above) and why?

We are not aware of any major challenges in auditing or enforcing the disclosures required by AG5.

(b) What are the practical challenges you would foresee in applying additional disclosures similar to those in Appendix 2 and/or applying disclosures as suggested in paragraphs 7(i) to 7(k) above?

The disclosure suggested at 7(i) focuses on the synergies and benefits expected to arise from common control combinations. While synergies may be present in certain common control combinations, it is not uncommon for entities to undergo common control combinations for reasons other than achieving synergies. In addition, we believe that the disclosure requirements in HKFRS 3 *Business Combinations* around synergies serve a different purpose, as synergies usually represent a major part of goodwill recognised under the acquisition method; no new goodwill is recognised as a result of merger accounting.

In addition, the purpose of making the additional related party disclosures as proposed at 7(j) is unclear. In preparing consolidated financial statements, intragroup transactions are eliminated and these transactions are not required to be disclosed under HKAS 24 *Related Party Disclosures*. As AG5 requires the combined entities or businesses under common control to present their consolidated financial statements as if the transferred entities or businesses had been combined when they first came under common control, which means all transactions between the acquirer and the transferred entities or businesses are eliminated to arrive at the consolidated financial statements presented, disclosing these related party transactions would appear to be inconsistent with the general disclosure principles under HKAS 24.

The term "involvement" as suggested in 7(j) is neither clearly defined in AG5 nor HKFRSs, which could result in practical difficulty in identifying what is discloseable as, by definition, the ultimate controlling party generally has a certain extent of involvement in the combination. Further, given the ultimate controlling party is not always the "controlling party" identified for the purpose of merger accounting, disclosing its involvement in the combination appears to be irrelevant to the current accounting treatment adopted.

As the transferred entity or business is measured at the existing carrying value from controlling party perspective, extensive effort and costs would be needed to prepare the proposed fair value disclosure requirements under 7(k) and appendix 2, whose costs may outweigh their benefits if users of financial statements are more concerned with the historical performance of the combined entities.

(c) How useful have you found the information that is presented in the financial statements based on the disclosure requirements of AG5?

We believe that generally the disclosures currently set out in AG5 provide a sufficient level of understanding to the financial statements users on the nature and effect of the common control combinations.

(d) How useful would the disclosures suggested in Appendix 2 and/or paragraphs 7(i) to 7(k) above be?

Please specify any other disclosures that would be useful, for example, identification of the 'controlling party'.

Many of the disclosures suggested in 7(i) to 7(k) as well as appendix 2 focus on the fair values of assets acquired and liabilities assumed in common control combinations. While these disclosures provide additional information on the latest values of the transferred entity or business, the extensive effort and costs in preparing them may outweigh their benefits as all these assets and liabilities are recognised at the existing carrying value from the controlling party perspective.

As discussed in our response to question 3 above, the measurement of the combined entities or businesses is based on the carrying value in the controlling party's consolidated financial statements, and in many cases there are more than one possible controlling parties. Accordingly, consistent with our response to 3(e) above, we believe that disclosing the identification of the controlling party is in some cases helpful to flag how the judgement could have a significant impact on the amounts recongised in the financial statements, in line with the principle in paragraph 122 of HKAS 1.

Question 8: Effects

From your point of view, which areas of AG5:

(a) represent benefits to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

AG5 provides practical accounting guidance on common control combinations, which helps enhance consistency on the accounting, presentation and disclosures of these transactions. Specifically it provides a common reference point for preparers, users and regulators on "how to" merger account, a critical area of accounting where IFRS or HKFRS are otherwise silent.

(b) have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why;

In case of type III combinations, the costs on restating and auditing comparatives may outweigh the benefits as the purpose of the financial statements is to assist financial statements users to assess the future performance of the combined entities or businesses.

(c) have had an effect on how common control combinations are carried out (for example, an effect on terms or structure of the combination); or

In our experience, the accounting for common control combinations under the current AG5 is usually fact and circumstances driven and entities generally apply judgments to prepare financial statements

that in their view best suit users' needs. Inevitably, given the nature of the issues, how a common control combination is structured could potentially affect the accounting outcome. For example, in Illustration 1, by introducing a newco above P3 in effecting the combination of S2 and S4, the newco's financial statements could achieve a 'pushdown' with respect to the carrying amounts of S4.

We believe that, however, there is no rules-based easy fix to these 'structuring opportunities'. If AG5 were to be revised to include guidance on designating the controlling party, there is still scope of structuring: using again Illustration 1 as an example, and assumes that P1 and P3 are both shell entities and there is a plan to combine the businesses of S3 and S4 – there could still be a different outcome depending on whether the combination is done by P3 acquiring S3 or by P1 acquiring S4, if UP or IP acquired P1 and P3 at a different time.

(d) requires more general guidance for other areas of the consolidated financial statements, such as the cash flow statement and earnings per share?

We consider the current guidance is sufficient and have received limited requests on additional guidance on these areas.