

1.

Please tell us:

(a) 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 users, regulator, academic, accounting professional body, etc) and your experience with accounting for common control combinations.

Answer:

We are the certified public accountants and serve as the auditors of a number of listed companies in Hong Kong which adopt HKFRS or IFRS for their preparation of financial statements. Besides, we have been engaged to act as reporting accountants of IPO engagements and disclosable transactions of companies listed on the Stock Exchange of Hong Kong Limited (the "HKEx") which involved common control combinations.

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?

Answer:

We have encountered the common control combination transactions for IPO engagements as well as the audit engagements of listed companies. In respect of the IPO engagements, merger accounting is always in use as such accounting method can enable the investors to have the complete picture of the financial information of the businesses/operations carried out by the listing applicants during the track record period. Besides, pursuant to the item 1.f. of Appendix 3 to the Auditing Guideline 3.340 of HKICPA, it is recommended that the historical financial information of the businesses/companies under common control but legally unconnected are formed into a legal group prior to issue or floatation for the purpose of the accountants' report to be prepared on a combined basis. Meanwhile, in respect of the common control transactions undertaken by the listed companies, they may account for these transactions with acquisition accounting under IFRS/HKFRS 3 or merger accounting which is considered as an accounting policy choice. However, if the listed company has adopted merger accounting for the common control combination for the group restructuring upon or before its listing on HKEx, it is considered that, for consistent accounting policy, all the common control combination transactions after listing should still adopt merge accounting. Other consideration for adopting acquisition accounting for common control combination transaction, which is also a related party transaction, is whether such transaction is carried out at arm's length. If the consideration in exchange is not determined based on arm's length negotiation, the resulting goodwill or discount on acquisition may be determined inappropriately.

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

Answer:

If merger accounting was applied to account for common control, it is noted that many entities did apply AG5 as most listed companies and listing applicants adopt HKFRS or IFRS of which AG5 is a practice guide in accounting for common control combination transactions. It should normally be followed given it is issued by the HKICPA and the application of AG5 is also the

expectation of the regulators in Hong Kong to oversee the listed companies and listing applicants on the capital market.

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.

Answer:

The predecessor method is relatively simple as compared with acquisition method under HKFRS 3 given no fair value measurement of the identifiable assets and liabilities of the combined entity at the date of common control combination is required. However, by putting those principles and procedures for merger accounting in practice, the following areas are identified to be unclear:

- paragraph 5 states that interspersing a shell entity between a parent entity and a single subsidiary does not represent the combination of two businesses and accordingly is not addressed in AG5. However, it is unclear whether interspersing a shell entity between a group of shareholders, no matter they are entity or individuals, and a single operating entity would be considered out of scope of AG5.
- paragraph 7 states "...as if the combination had occurred from the date when the combining entities or businesses first came under the control of the controlling party or parties". As described illustration 1, there are cases that more than one level of controlling party of the combining entities or businesses in practice. Different levels of controlling party may have different consolidated balances for the same assets and liabilities of the combining entities or businesses.
- the phrase of "combining entities" includes both the reporting entity itself and those entities which become subsidiaries of Company A. Paragraph 10(a) states that "...the net assets of the combining entities or businesses are consolidated using the existing book values from the controlling parties' perspective...". In a scenario that the reporting entity (Company A) was acquired by its parent a few years ago and another subsidiary of its parent (Company B) is combined with Company A through acquisition of Company B by Company A from the parent as part of the reorganization for its IPO, applying the procedures described above would potentially result in changes of the carrying amounts of the assets and liabilities of Company A and recognition of goodwill in the financial statements of Company A based on the acquisition accounting adopted in the parent's consolidated financial statements. It is unclear whether this is the intended accounting treatment to change the carrying amount of the reporting entity's own assets and liabilities when the concept of predecessor method is adopted.
- paragraph 10(c) states "...comparative amounts in the financial statements are presented using the principles as set out in paragraph 10(a)...unless the combining entities...first came under common control at a later date". If the acquisition of Company A by the parent as mentioned above was happened in the second year of the three-year track record period as presented and Company B was incorporated by the parent before the three-year track record period, it is unclear without further guidance that whether the consolidated financial statements of the combined entity, i.e. Company A, shall present the financial information of Company B only for the first year when adopting paragraph 7, i.e. as if the combination has occurred from the date when Company A and Company B first came under the control of the parent which shall be the second year of the three-year track record period at the time the parent acquired Company A.

- paragraph 10(a) states that "when the controlling party does not prepare financial statements, the carrying amounts of the acquired entity are included as if such consolidated financial statements had been prepared", the application of this procedure without further guidance may be difficult in certain cases, details of which are described in the answer to Q3(d) below.

(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.

Answer:

As mentioned in answer to Q3 (a), the principles and procedures in AG 5 are not clear enough. There are rooms for interpretation of these guidance and choice of "carrying amounts" by the preparers of the financial statements of the combined entity. To deal with these challenges, it is not uncommon that the preparers of consolidated financial statements of the combined entity would do research on the common practice and other similar precedent cases to decide how those principles and procedures are to be applied appropriately and such treatment is adopted so long as it is not inconsistent with AG5. Others also considered detailed disclosures of the specific principles and bases applied under merger accounting in the note to the financial statements are important and necessary for the readers to understand the specific accounting treatment, if any, adopted for the common control combination transaction or group reorganization.

(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.

Answer:

Under the scenario of Illustration 1, the initial accounting shall be from the date the controlling party obtained control over the combined entity (S2). The unclear definition of "controlling party" can create different picture depending on whether the controlling party is considered to be UP or IP/P2 since the acquisition dates of UP acquiring IP and IP/P2 acquiring S2 are different.

Using Illustration 1, it is considered that it may be more appropriate to treat UP as the "controlling party" as it is the party currently having control over the common control combination transaction to be entered into. Other considerations include understanding on the underlying nature and economic substance of the transaction; changes in the common controlling party during the periods presented; whether the transferred entity was previously purchased from a third party (that is, goodwill was recognized when the acquired entity became part of the group); the practicability to adopt the desirable treatment; the reasonableness of the outcome under each scenario and the common practice and treatment of other similar precedent cases.

(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.

Answer:

There may be practical problems to use the existing book values from the controlling party's perspective for the following reasons:

- In case the controlling party is an individual instead of an entity and he/she acquired the combined entity in many years ago, it will be difficult to find out the financial information of the combining entity, both the carrying amount and the then fair value of the assets and liabilities, at the date the individual obtained control over it since the individual is not required to prepare a financial statement of him/herself;
- even for the case that the controlling party is an entity, if the controlling party obtained control over the combining entity very long time ago and it has never prepared financial statements in the past, it will be difficult to assess the carrying amounts of identified assets and liabilities of the combining entity and the corresponding goodwill arising from the previous acquisition date which should have been incorporated in the financial statements of the controlling party. Besides, the books and records of the combining entity at the date of the acquisition by the controlling party may have been lost due to such long time; and
- in a case that the controlling party has not prepared financial statements under IFRS or HKFRS, it will also be difficult to determine whether the existing book values from the controlling party's perspective are appropriate for the merger accounting under AG 5 in a set of HKFRS or IFRS financial statements.

Depending on the background, fact and circumstances of each individual case, the preparers of the financial statements of the combined entities may use some qualitative assessment to see if there should be any goodwill arising at the date of obtaining control over the combining entities or businesses by the controlling party and to see if the relevant assets and liabilities at the date of obtaining control have been fully depreciated/amortized or expired/extinguished as of the date of the group reorganization currently undergone.

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.

Answer:

Due to the unclear definition of the "controlling party", the interest accounted for as minority interests may not be affirmative.

(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.

Answer:

Same as (a) above. Besides, in a case that, for instance, two entities have the same two shareholders, one is controlling shareholder and another is holding minority interest. A combination of these two entities with interspersing a shell entity between two shareholders (with same % ownership before and after) and the two entities by adopting the principles and procedures mentioned in Q3 would result in presentation of minority interests for the periods before such combination. Certain users of the financial statements of the combined entity

may be confused about the rationale of this accounting treatment and considered it is not meaningful to treat the minority shareholder's interest in two entities different to that for the controller shareholder given the restructuring may not change the substance of the beneficial interest of both shareholders before and after the combination.

To deal with these challenges, it is not uncommon that the preparers of consolidated financial statements of the combined entity would do research on the common practice and other similar precedent cases to decide how those principles and procedures are to be applied appropriately and such treatment is adopted so long as it is not inconsistent with AG5. Others also considered detailed disclosures of the specific principles and bases applied under merger accounting in the note to the financial statements are important and necessary for the readers to understand the specific accounting treatment on minority interest, if any, adopted for the common control combination transaction or group reorganization.

(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?

Answer:

It is considered appropriate to record the minority interests for entity S2 in the consolidated balance sheet and consolidated income statement of entity P3 as to 0% upon the completion of transfer of S2 and as to the effective interest held by others apart from those held by UP and its subsidiaries for those relevant times prior to the transfer of S2 to S3.

No minority interest will be shown in the consolidated financial statements of P3 when it wholly owned all its subsidiaries including S2 even P3 is not wholly owned by its parent after the restructure.

The level of controlling party when accounting for minority interests in common control combination should be consistent with that considered for the application of paragraph 10(a) using the "existing book values from the controlling parties' perspective".

5. Applying principles of AG5: Comparatives

(a) 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.

Answer:

Same as Q3 (a) and (d).

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?

Answer:

In those common control combinations, it is very common to use shares as consideration paid for the acquired entity. Cash consideration may be normally happened when share swap is not possible in certain jurisdictions. In certain cases, even cash is used as the consideration paid, the controlling shareholders contributed the cash received from the group company who is the acquirer under the group reorganization to the reporting entity and as a result, there is no consideration in substance for the transfer. A combination of cash and shares may also happen.

(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?

Answer:

For those cases the form of consideration is cash instead of shares, it will be accounted for in the period when the contractual obligation to pay actually arose as a reserve movement which would not have any accounting implication for the comparative years.

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?

Answer:

There are no particular challenges in preparing, auditing or enforcing the disclosures required by AG5 except that:

- the disclosure requirements under paragraph 19(d) of AG 5 seem to be onerous given there are no similar disclosure requirements under HKFRS 3 or HKFRS 12 for consolidated financial statements with business combination accounted under acquisition method; and
- it is unclear about the disclosure requirement of "a statement of the adjustments to consolidated reserves" under paragraph 19(e) of AG 5.

(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?

Answer:

The additional disclosures may not have practical challenges except the preparer of the financial statements of the combined entity may consider it is onerous to obtain and disclose the information of the fair value of the net assets transferred entity/business as suggested in paragraph 7(k) and of the acquisition date fair value of the consideration transferred involving equity interest of the acquirer under HKFRS 3 if those fair values have not been adopted for accounting purpose under AG5.

8.

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;

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

(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

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

Are there other matters that you think the HKICPA should be aware of as it considers the application of AG5? These matters may include, but are not limited to: (i) the usefulness of information provided by AG5; (ii) practical implementation matters; and (iii) any learning points for our standard-setting process.

Answer:

Details of specific comments, including practice issues encountered, on application of merger accounting and disclosure under AG 5 have been described in the answers to the previous questions. Additional guidance and examples on certain areas may reduce the diversity in practice and enhance the understanding of such related party transaction by the users of financial statements.