

Meeting Summary

Discussion on HKICPA Request for Information: PIR of AG 5

Date: 14 September 2016

Venue: Practitioners' offices

Participants:

Not disclosed, practitioners

Applying principles of AG 5: Controlling party and carrying value

1. With respect to Illustration 1 in the RfI, these practitioners commented that IP may be identified as the controlling party. This is because:
 - a) the IP management team has immediate and direct control of the affected parties. That is, the direct control of both subgroups P2 and P3.
 - b) it directly consolidates both subgroups P2 and P3 which have disposed of and acquired S2, respectively. That is, accounting symmetry is effectively maintained.
2. One of these practitioners commented that identifying who is the controlling party remains one of the major challenges. He also commented that a frequent question received is whether the same controlling party that was previously identified should be identified as the controlling party in future combinations. For example, if IP is identified as the controlling party as in Illustration 1 of the RfI, would IP be required to be identified as the controlling party in another common control combination that takes place within the same overall group?
3. One of these practitioners further explained that in more complicated group structures, subsidiaries may be transferred between separate sub-groups controlled by different intermediate parent companies. Under such circumstances, it is difficult for practitioners to determine where the decision making is undertaken. She proposed that AG 5 could include a basis for conclusion or a guideline for identifying the controlling party under such scenarios.
4. At the moment, clients are asked to decide who the controlling party is and they usually make the decision based on the practicability of obtaining the necessary information for financial reporting. Certain financial information may not be readily available if the controlling party is the ultimate parent and is an individual or a foreign private company using a different GAAP. In such a case an intermediate parent which prepares IFRS/HKFRS financial statements would be chosen as the controlling party.
5. Another major challenge was what is considered to be 'not transitory'. One of the practitioners commented that in many cases, there may be a change in control subsequent to an IPO. He noted that in these cases, his firm would typically assess the period of common control in totality—for example, if the common control remains the same both before and after the restructure for more than 3 years, then this may be deemed as 'not transitory'.
6. Finally, these practitioners think that the possible diversity in identifying the

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'controlling party' would impair investors/analysts understanding of financial statements. This is because investors/analysts have no way of inferring which values have been used in the common control combination.

Applying principles of AG 5: Minority Interests

7. One of the practitioners observed that preparers generally have concerns with the presentation of minority interests after the common control combination. She further explained that, following AG 5's principle, minority interests should be presented from the controlling party's perspective prior to the common control combination. However, preparers do not understand the rationale behind that, as financial statements under IFRS/HKFRS's are typically prepared from the reporting entity's perspective as of the balance sheet date. This is especially a concern in cases where a business entity is undergoing IPO.

Applying principles of AG 5: Comparatives

8. One of the practitioners is aware that preparers do not understand why comparatives should be restated to reflect the combination as if it had already taken place in prior year(s). Preparers think that this AG 5 principle contradicts the principle of IFRS 10 *Consolidated Financial Statements*, which states that consolidation shall start at the time when control is achieved. Therefore AG 5's restatement of comparatives for a common control combination theoretically challenges the requirements of IFRS 10. Their firm's internal guidance requests the company to make an accounting policy choice, which should be applied consistently to future combinations and disclosed in financial statements.
9. One of the practitioners also commented that financial statements prepared for IPO are generally prepared on a combined basis and are special purpose reports to meet the listing requirements. Post-IPO financial statements are generally prepared as general purpose reports for statutory purposes, and therefore restating comparatives may not be necessary following the principles of IFRS 10.
10. In practice, these practitioners commented that companies undergoing IPO usually will restate comparatives as it helps them to meet the Hong Kong Stock Exchange requirement for a 3-year track record period. They are aware that listed companies do not find the restatement of comparatives helpful as it is only a hypothetical benchmarking of prior year results (using current year group structure), which requires more time-cost to prepare.

Accounting for consideration paid

11. These practitioners commented that in practice, financial statements are prepared by combining all the assets and liabilities of the combining entities. The difference between the consideration paid and the combined entities is generally

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recognized in the merger reserve. This will be the same for both the current and comparative periods of the financial statements.

12. In practice, the form of consideration does not change the fact that when accounting for the consideration paid in comparative periods (assuming the common control combination had not yet occurred), it does not meet the definition of a financial liability as per IAS 32 (as it did not exist). Therefore, no 'consideration payable' or credit to the cash balance would be recognized. In addition, one of the practitioners commented that for group reorganizations, contingent consideration is rarely seen unless the underlying condition does have economic substance.
13. In terms of the measurement of consideration, one of the practitioners commented that for a listed company to perform a common control combination, the consideration is normally at fair value. This is because public investors or minority shareholders would expect the acquired business to be valued at market value.

Applying principles of AG 5: Disclosures

14. One of the practitioners commented that it is important to disclose who the controlling party is and how it is identified, and how minority interest is identified and measured.
15. One of the practitioners also commented that disclosures about EPS are also important and challenging. There will normally be changes in the capitalization of reorganizations and hence correct recalculation of EPS is often seen as difficult.

Other matters

16. Their firm's internal guideline prescribes a policy choice of merger accounting or acquisition accounting as long as the policy choice is consistently applied to other common control combinations. However, if the transaction has no business substance, the view is to adopt the merger accounting principle. Business substance is determined by looking at: the purpose of the transaction, the parties involved, the existence of minority interests, whether the consideration is at fair value and whether the combination changes the activities of the group.
17. These practitioners also suggested that should a basis for conclusions be added to AG 5, defining the terms 'combined entity', 'combining entities', and 'controlling party' would be useful.