Meeting Summary
Discussion on HKICPA Request for Information: PIR of AG 5

Date: 9 November 2016

Venue: Offices of the preparers

Participants:

Not disclosed, CFO

Not disclosed, General Manager

Not disclosed, Assistant to General Manager

Elza Yuen, PwC, Director

Reason for adopting predecessor method

1. The company is listed both in the Hong Kong Stock Exchange and the Shanghai Stock Exchange in PRC. Therefore the company issues one set of financial statements under China Accounting Standards in PRC ("CAS") and a set of financial statements under HKFRS. CAS only allows the predecessor method when accounting for combinations under common control. To keep the consistency between the PRC financial statements and the Hong Kong financial statements, the company decided to adopt merger accounting under AG5. However, the CFO mentioned if CAS allows an alternative accounting method he would prefer to use the acquisition method under HKFRS 3 over the predecessor method. In his view, the acquisition method better reflects the economic substance of the group's common control combinations.

Determining the controlling party and carrying value

2. The company acquired a common control business in 2015. The acquired business was wholly incorporated by the ultimate parent (no minority interest). The carrying values reported by the acquired business and the ultimate parent were therefore the same. Since there was no difference in carrying values, it was not necessary to determine who the controlling party was.

Challenges encountered in accounting for common control combinations

3. The CFO commented that prior year restatements (two years) are extremely time consuming and requires significant man power. From that angle, the acquisition method is more advantageous than the predecessor method.
4. Furthermore, the predecessor method increases the difficulty for management to accurately evaluate actual business performance (as the restated comparatives of the reporting group are pro-forma information). This is explained in more detail below.

Meeting Summary
Discussion on HKICPA Request for Information: PIR of AG 5

<u>Other comments: effects</u>

5. In the CFO's view, the merger accounting method under AG5 can have a negative implication to the new controlling entity's management. AG5 requires comparative numbers in the financial statements to be presented as if the entities or businesses had been combined at the previous balance sheet date. Under such requirement, the acquiring entity's profit & loss for the comparative years will be restated even though the acquisition had just taken place. This conceals any past bad performances or alters past good performances in the previous years and impacts the assessment of management's performance.
6. The CFO also believes that the principle of restating comparatives creates an incentive for a non-performing company to acquire a 'performing' related party to boost its performance.
7. At the same time, he is aware that reporting using the acquisition method can create an opportunity for artificially overstating the fair values and, essentially, the overall financial health of a company. He thinks another incentive for using the acquisition method is tax savings. A company may recognize goodwill on the acquisition and subsequently recognize impairment on the goodwill. That impairment expense would be tax deductible.
8. The CFO considers it is appropriate to offer a choice between acquisition method and predecessor method. He supports developing sound bases for when the acquisition method and predecessor method should be used.
9. AG5 does not contain any guidance with respect to cashflow. Currently, cash considerations paid for the acquired common control entities have been presented as a financing activity in the consolidated cash flow. However, the CFO thinks that in substance these cash outflows would be more appropriately presented as an investing activity in the consolidated cash flow. Some clarity in AG5 would be useful.