

Meeting Summary

Discussion on HKICPA Request for Information: PIR of AG 5

Date: 11 November 2016

Venue: Offices of Hong Kong University

Participants:

Zhang Guochang, Hong Kong University, Professor/Academic

Applying the Conceptual Framework against common control combinations

1. As a general principle, Prof. Zhang believes that:
 - the balance sheet should be a record of the contribution/input value in a company as at a particular date, and not a reflection of expected future values; and
 - the comprehensive income should be a record of a company's output or performance, and not a reflection of how much an investor spent/invested in the company.
2. Useful information is defined under the Conceptual Framework (per the IASB's October 2016 tentative decisions) as information that:
 - faithfully represents the substance of an economic phenomenon, and
 - is relevant to users by being capable of making a difference in the decisions made by users.
3. Prof. Zhang commented that, theoretically, relevance should be the most important factor in determining what useful information is, as it is the most practical factor from a users perspective—what is relevant to users will determine what is its' most faithful representation.
4. However, he acknowledges that this theory will not always result in the same accounting outcome when applied against various scenarios for common control combinations. For example:
 - (a) Where the consideration paid in a common control combination is at fair-value, then relevance to users would be reflecting the transaction using the acquisition method. Applying Prof. Zhang's general principle, the acquisition method would more appropriately reflect the consideration at fair value paid by investors onto the Balance Sheet.
 - (b) Where the consideration paid in a common control combination is not at fair-value, then it would not be relevant to users to reflect the transaction using the acquisition method. In these cases, it would be more relevant to users to faithfully represent the lack of economic substance in the transaction', such as using the predecessor method. Applying Prof. Zhang's general principle, the predecessor method would more appropriately reflect the lack of economic substance or nominal consideration paid by investors onto the Balance Sheet.

Meeting Summary

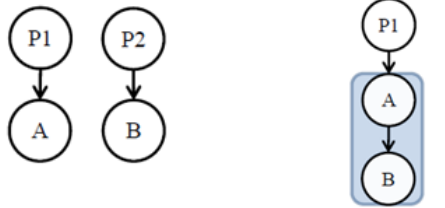
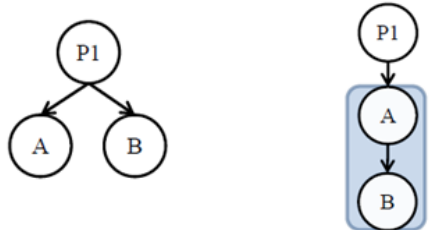
Discussion on HKICPA Request for Information: PIR of AG 5

- Therefore, in general, Prof. Zhang commented it would be more practical to first determine what is relevant to the primary user. This is because faithful representation will always vary depending on the stakeholders' perspective.

Economic substance in a BCUCC versus an external Business Combination

- Prof. Zhang suggested that understanding the underlying economic substance of third party business combinations versus BCUCCs would help determine a useful and relevant accounting method for BCUCC.
- Underlying economic substance could include drivers such as changes in management and/or 'real' changes in cashflow or taxation.

The following scenarios (BC and BCUCC performed by a private company) were discussed:

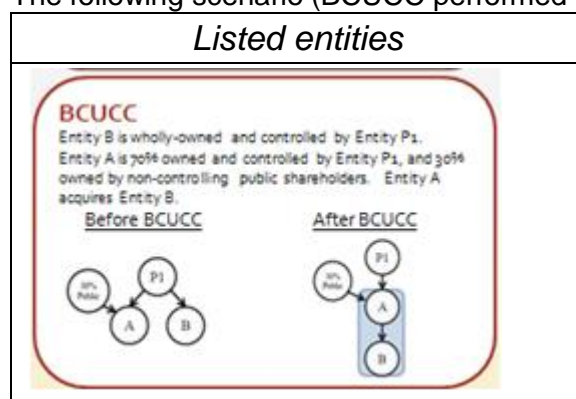
| | |
|--|---|
| <p>BUSINESS COMBINATION</p> <p>Entity A and Entity B are controlled by different parties, P₁ and P₂, respectively. Entity A acquires Entity B.</p> <p><u>Before BC</u> <u>After BC</u></p>  <pre> graph TD subgraph Before_BC [Before BC] P1((P1)) --> A((A)) P2((P2)) --> B((B)) end subgraph After_BC [After BC] P1((P1)) --> A((A)) A --> B((B)) end </pre> | <p>8. For third party business combinations, Prof. Zhang commented that since the acquisition of B arises from an external third party, typically the consideration would be at fair-value and goodwill would be generated.</p> <p>In substance, there is a change in ownership and economic substance from both P₁ and A's perspective.</p> |
| <p>BCUCC</p> <p>Entity A and Entity B are controlled by the same party, P₁. Entity A acquires Entity B.</p> <p><u>Before BCUCC</u> <u>After BCUCC</u></p>  <pre> graph TD subgraph Before_BCUCC [Before BCUCC] P1((P1)) --> A((A)) P1 --> B((B)) end subgraph After_BCUCC [After BCUCC] P1((P1)) --> A((A)) A --> B((B)) end </pre> | <p>9. For BCUCCs, Prof. Zhang commented that the economic substance of the transaction would be different depending on the perspective of P₁ or A.</p> <p>From the perspective of P₁, it is arguable that there is no change in control and economic substance.</p> |

Meeting Summary

Discussion on HKICPA Request for Information: PIR of AG 5

| | |
|--|---|
| | <p>From the perspective of A, it has control of an additional entity subsequent to the transaction. Therefore, there is a change in economic substance.</p> |
|--|---|

The following scenario (BCUCC performed by a listed entity) was discussed:

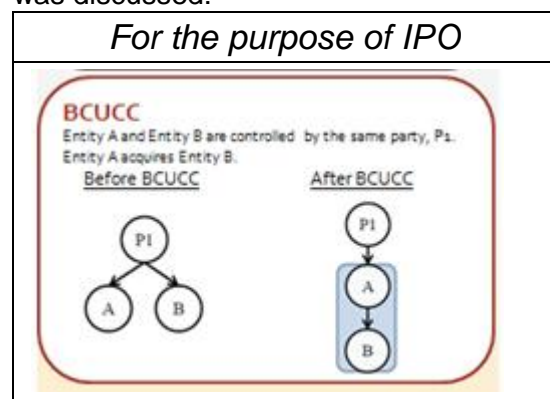


10. Assuming A is a listed reporting entity, Prof. Zhang commented that there is a change in economic substance from A's perspective—A now has 100% control of B and would have to consolidate 100% of B's results. In this case, the acquisition method should be elected to account for the common control combination. This is mainly because the public investors of A would expect the transaction to be carried out at arm's length and at fair value. Therefore, adopting the acquisition method would be more relevant from their perspective.
11. From P1's perspective, Prof. Zhang thinks that theoretically, not much may have changed in terms of group structure—P1 still holds majority control of B. The only change is that P1 now controls B indirectly via A, and has a reduction of 30% in ownership. Therefore, from P1's perspective, the predecessor method is arguably more relevant.
12. However, Prof. Zhang thinks if P1 is also listed, then consistency is paramount, and consolidating the results of A sub-group (using the acquisition method to account for the common control combination) would be more relevant to P1's public investors.
13. Nevertheless, Prof. Zhang acknowledges that particularly in cases where the consideration is at fair value and paid in cash, from P1's perspective it may be difficult to justify the acquisition method—that is, the transfer of cash from A to P1 (at the fair value of B) in return for a decrease of 30% ownership in B.

Meeting Summary

Discussion on HKICPA Request for Information: PIR of AG 5

The following scenario (BCUCC performed by a private group for the purpose of IPO) was discussed:



14. In IPO situations, the primary users are the potential investors. New shareholders making a contribution into A (being the listing company) would want to know the value of the potential investment brought about by A and B as a group even though the BCUCC took place just before IPO.
15. Applying Prof. Zhang's general principle to common control combinations (for IPO reasons), potential investors in A (being the listed company) would want to know what is the value of A and B combined today, and not the historical values or the expected future synergies of acquiring B (goodwill). As such, what is relevant for these potential investors could be Fresh Start accounting, whereby both A and B are reset at fair value and therefore represents the fair value of the whole listing group.
16. If the BCUCC is conditional on a successful IPO, then Fresh Start accounting would also be more useful because of the change in overall investor shareholding.