



5 August 2016

**To: Members of the Hong Kong Institute of CPAs
All other interested parties**

**HKICPA REQUEST FOR INFORMATION:
Post-implementation Review of Accounting Guideline 5
*Merger Accounting for Common Control Combinations***

Comments to be received by 2 December 2016

The Financial Reporting Standards Committee ("FRSC") of the Hong Kong Institute of Certified Public Accountants ("Institute") is requesting for information on the application of Accounting Guideline 5 *Merger Accounting for Common Control Combinations* ("AG5"). The Request for Information is available on the Institute's website at:
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>

The Institute issued this Request for Information ("RfI") to conduct a post-implementation review ("PIR") of AG5. A PIR is a key part of our standard-setting process to proactively seek constituents' feedback on and assess the benefits, challenges and other effects of applying our pronouncement. The Institute welcomes feedback from everyone: preparers of financial statements, market regulators, the audit profession, valuation specialists, academics as well as the investor community or other users of financial statements. The feedback will provide the FRSC with useful information to consider its next steps, which may involve assessing areas of AG5 that may need improvement. A PIR does not formally commit us to undertake a project to revise AG5.

The findings from our PIR will also be shared with the International Accounting Standards Board to assist in its research on business combinations under common control.

The Institute requests for your response by 2 December 2016. Your response should be supported by specific reasoning and should ideally be submitted in written form. The Institute would also welcome the opportunity to meet with interested parties in person to discuss the RfI.

You may contact us in the following ways:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the respondent.

Comments due by
2 December 2016

Request for Information on

Post-implementation Review:

***Accounting Guideline 5 Merger Accounting
for Common Control Combinations***



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Introduction

A combination of entities or businesses under common control ("common control combination") is specifically excluded from the scope of IFRS/HKFRS 3 *Business Combinations*¹ and there is no IFRS/HKFRS that deals with such transactions. To fill this gap, in 2005, the Hong Kong Institute of Certified Public Accountants ("HKICPA", "we", "us", "our") issued Accounting Guideline 5 *Merger Accounting for Common Control Combinations* ("AG5").

AG5 sets out the basic principles and procedures of merger accounting when recognising a common control combination. As with any Accounting Guideline issued by the Institute, AG5 has effect as a guidance statement and indicates best practice. It is persuasive in intent. Unlike HKFRSs, AG5 is not mandatory on members of the HKICPA but is consistent with the purpose of HKFRSs in helping to define accounting practice in accounting for certain common control combinations. Therefore, it should normally be followed and members of the HKICPA should be prepared to explain departures if called upon to do so².

The Institute issued this Request for Information ("Rfi") to conduct a post-implementation review ("PIR") of AG5. A PIR is a key part of our standard-setting process to proactively seek constituents' feedback on and assess the benefits, challenges and other effects of applying our pronouncement. The Institute welcomes feedback from everyone: preparers of financial statements, market regulators, the audit profession, valuation specialists, academics as well as the investor community or other users of financial statements. The feedback will provide the Financial Reporting Standards Committee of the HKICPA with useful information to consider its next steps, which may involve assessing areas of AG5 that may need improvement. A PIR does not formally commit us to undertake a project to revise AG5.

This Rfi on the application of AG5 is not a review on whether entities have accounted for common control combinations correctly, nor is it an indication of how AG5 should be applied in practice.

The questions we are asking about the application of AG5 are set out in this document. The principles, procedures and example as set out in AG5 are included in Appendix 1 of this Rfi. Please refer to Appendix 1 when responding to the questions about AG5.

1 HKFRS 3 is the equivalent of IFRS 3 of the same name as issued by the International Accounting Standards Board.

2 Refer Paragraph 35 of the *Preface to Hong Kong Financial Reporting Standards*.

Request for Information

This RfI focuses on specific areas of AG5 that have been identified as important by targeted stakeholders comprising technical experts from accounting firms, preparers of financial statements, representatives of regulators and members of the investor community.

In particular, this RfI aims to assess whether: (a) AG5 identifies information that is useful to users of financial statements; (b) there are areas of AG5 that represent implementation challenges and, as a result, impair the consistent implementation of AG5; and (c) unexpected costs have arisen when preparing, auditing or enforcing AG5 or when using the information provided by AG5.

We will consider the responses received via written submission along with information gathered through a range of outreach activities to assist with gathering feedback to this RfI. The process is open and transparent—all responses received and meeting notes from our discussions will be published on the HKICPA's website (unless the respondent requests confidentiality).

The findings from the RfI will be analysed and a feedback statement summarizing the findings and planned next steps will be issued. All key findings from the RfI will be shared with the International Accounting Standards Board to assist with its research project on business combinations under common control.

You do not have to answer every question and you are encouraged to provide information on any additional matters that you think are relevant for our review of the application of AG5. Information is most helpful to us, in our assessment of the effect of applying AG5, if it is supported by examples from published financial statements or other relevant evidence.

Some questions are targeted at preparers or users of financial statements. All other stakeholders are also welcome to respond to these targeted questions based on what you have commonly seen or experienced in the market. We will consider all responses received by 2 December 2016 and make our assessment on the merits of the information provided, not on the number of responses to each question.

1. Your background and experience

It is easier for us to understand the information that you give us if we know what your role is with respect to financial reporting and what your experience is in accounting for common control combinations.

If you work in a non-HKFRS environment or have not applied AG5 because the common control combinations you have encountered did not meet the criteria for application of AG5, your input is still useful to us. In such a case, please explain why the criteria was not met, and what is your accounting policy and application method in accounting for common control combinations.

Question 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 user³, regulator, academic, accounting professional body, etc) and your experience with accounting for common control combinations.

Question targeted at preparers of financial statements

- (b) Please tell us:
- (i) what are the principal activities of your company;
 - (ii) whether your company prepares financial statements under HKFRS; and
 - (iii) how often have you encountered common control combination transactions?

Question targeted at users of financial statements

- (c) Please briefly describe the main common control combinations that you have analysed (for example, the type of company⁴ in which these transactions took place, the underlying purpose and nature for which those transactions took place, the accounting policies for those common control combinations, and how the accounting impacted your analyses, etc).

2. Scope and authority of AG5

The background of AG5 is explained on page 1 of this RfI. AG5 is intended to be applied when:

- (a) an entity prepares financial statements in accordance with HKFRS;
- (b) the entity has identified a common control combination; and
- (c) the entity has elected to apply merger accounting for the common control combination.

It is not intended to be applied when interspersing a shell entity between a parent entity and a single subsidiary.

Question 2

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

³ Type of user includes: buy-side analyst, sell-side analyst, credit rating analyst, creditor/lender, other (please specify).

⁴ Type of company includes: entities undergoing an initial public offering and/or listed entities on the Hong Kong Main Board or Growth Enterprise Market, private family-run companies, unlisted Hong Kong subsidiaries of multinational corporations headquartered overseas, other (please specify).

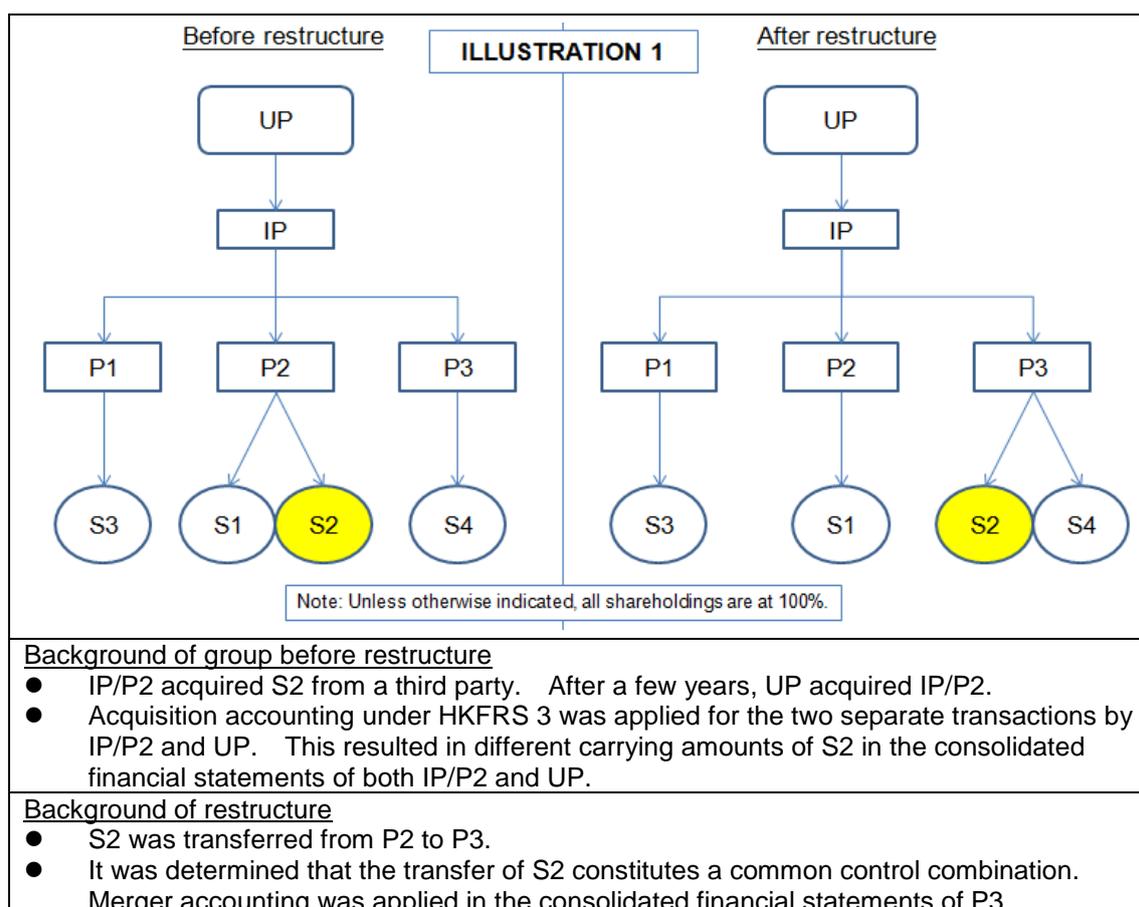
3. Applying principles of AG5: Controlling party and carrying values

AG5 states that the assets and liabilities of the acquired entity or business should be recorded at the book values as stated in the financial statements of the 'controlling party'. However, AG5 does not define 'controlling party'.

Illustration 1 below demonstrates the multiple layers of control that could exist within a group. Because AG5 does not define 'controlling party', one could therefore identify more than one party to be the controlling party, for example, in this illustration it could be the ultimate parent (UP) or intermediate parent (IP) as the controlling party for the purposes of applying AG5.

Why are we seeking feedback on this area?

Book values may include the fair value of the identifiable assets and liabilities of the acquired entity or business at the date of original acquisition from third parties by the controlling party and any remaining goodwill as a result of the initial acquisition into the group. Therefore, in Illustration 1 below, the book values of S2's assets and liabilities used in accounting for the common control combination may differ depending on whether IP or UP is identified as the controlling party.



Question 3

- (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.

Questions targeted at preparers of financial statements

- (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.
- (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.
- (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.

Questions targeted at users of financial statements

- (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.
- (f) Using Illustration 1, how useful has P3's resulting financial information been for your analysis? For example, would the existing book values from UP or IP make a difference to your analysis? Please explain why.

4. Applying principles of AG5: Minority interests⁵

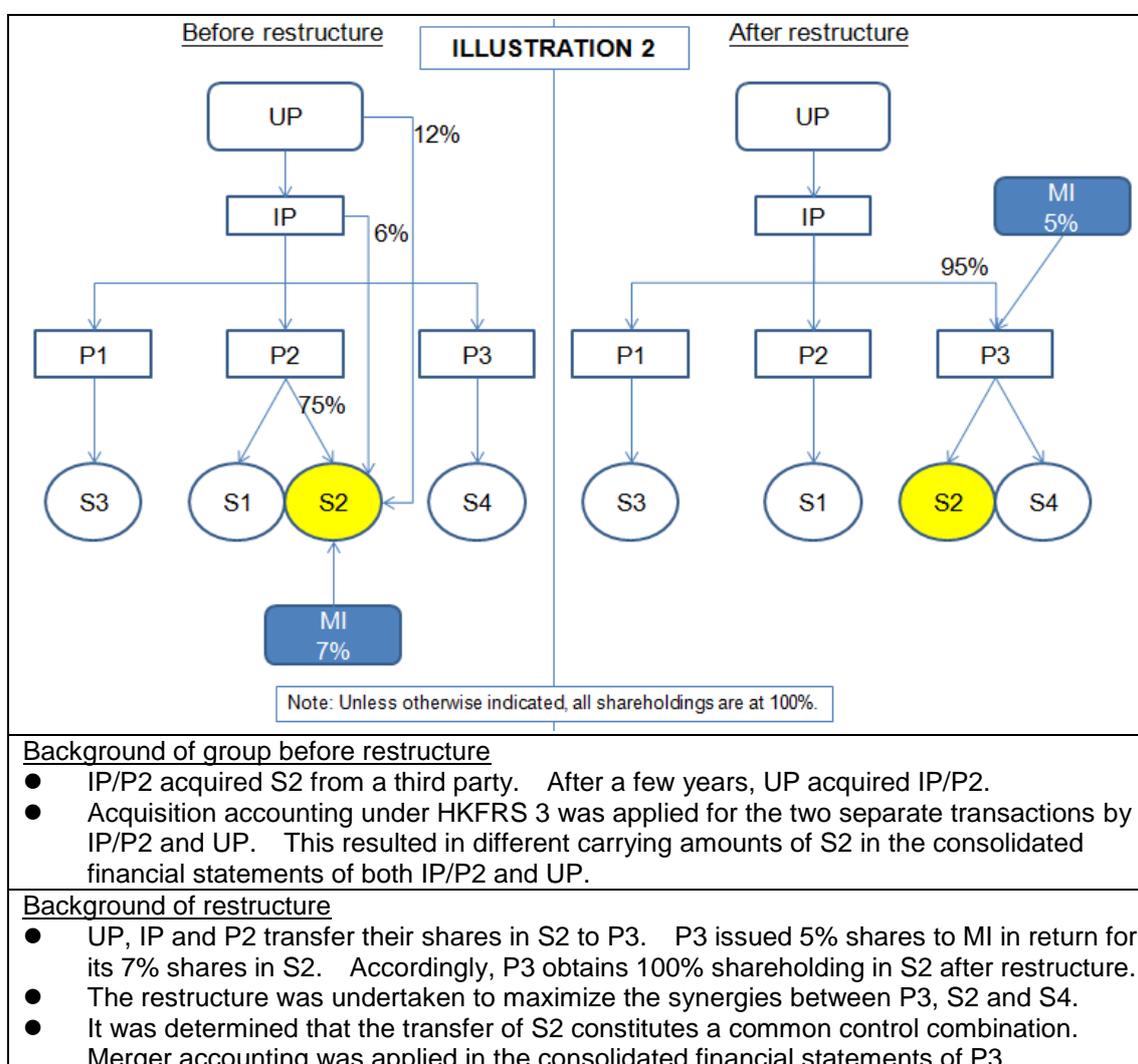
A similar issue as described in section 3 above arises in respect of minority interests. AG5 does not deal with how to determine minority interests where there is more than one level of controlling party and contains a simple example.

⁵ The 2008 amendments to HKAS 27 *Consolidated and Separate Financial Statements* changed the term 'minority interest' to 'non-controlling interest'. The term 'minority interest' is used throughout this document for consistency with AG5 text. The term 'non-controlling interest' is defined in HKFRS 10 *Consolidated Financial Statements*.

The example within the Appendix of AG5 illustrates only one level of controlling party, being Entity P. In that example, the consolidated financial statements (including comparatives) of Entity A reflects: (i) minority interests of 25% for Entity Y up to the date of combination; and (ii) minority interests of 0% for Entity Y as at the date of combination.

Why are we seeking feedback on this area?

Where there is more than one level of control (as shown in Illustration 2 below), the minority interest recognised may differ depending on which entity is identified as the controlling party. In Illustration 2 below, the minority interest used by P3 in accounting for the common control combination in the comparative financial statements and up to the date of the combination could be 7% (if UP is identified as the controlling party⁶) or 19% (if IP is identified as the controlling party⁷). Minority interest as at the date of combination is 0%.



6 UP's direct holdings in S2 is 12%. It's indirect holdings in S2 (through IP/P2) is 6% and 75%. Hence, the minority interest from the perspective of UP is 7%.

7 IP's direct holdings in S2 is 6%. It's indirect holdings in S2 (through P2) is 75%. Hence, the minority interest from the perspective of IP is 19%, that is, the sum of UP and MI's direct holdings in S2 (12% and 7% respectively).

Question 4

- (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.

Questions targeted at preparers of financial statements

- (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.
- (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?

Questions targeted at users of financial statements

- (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.
- (e) Using Illustration 2, and assuming that the common control combination had taken place in the current year, how useful has P3's resulting financial information been for your analysis? For example, would P3's comparative financial statements reflecting minority interests from the perspective of UP (7%) or IP (19%) make a difference to your analysis when minority interests at the date of combination is 0%? Please explain why.

5. Applying principles of AG5: Comparatives

The principle of using merger accounting for the accounting of common control combinations is that no acquisition has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination. Therefore, the combining entities or businesses are accounted for as though the separate entities or businesses were continuing as before.

Comparative amounts in the consolidated financial statements of the combined entity following a common control combination are presented using the principles as set out in paragraph 10(c) of AG5. That is, comparatives are presented 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.

Question 5

- (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.

Question targeted at users of financial statements

- (b) How useful have you found the resulting presentation of financial statements (including comparatives)?

6. Accounting for the consideration paid

AG5 does not prescribe how to measure consideration paid (shares, cash or other), but provides an illustrative example in the Appendix. The example deems the value of the non-cash consideration as the book value of the net assets plus previous goodwill recognised by the initial parent in its consolidated financial statements, if any. Note that the deemed cost used in the AG5 example is for illustrative purposes only and does not necessarily represent the value to be reported in the acquirer's individual financial statements as the cost of acquiring the subsidiaries.

Question 6

- (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?
- (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?

7. Applying principles of AG5: Disclosures

Paragraphs 16 to 19 of AG5 requires entities applying AG5 to disclose the following in their consolidated financial statements:

- (a) the fact that AG5 has been used;
- (b) the accounting policy applied in accounting for a common control combination by using the principles of merger accounting, which shall include, but is not be limited to, a discussion of the specific principles and bases applied under merger accounting;
- (c) significant details of the common control combination;
- (d) the names of the combining entities (other than the reporting entity);
- (e) the date of the common control combination;
- (f) the composition of the consideration and fair value of the consideration other than shares issued;

- (g) the nature and amount of significant accounting adjustments made to the net assets and net profit or loss of any entities or businesses to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets and net profit or loss of any entity or business as a consequence of the common control combination; and
- (h) a statement of the adjustments to consolidated reserves.

Based on our preliminary outreach with targeted stakeholders, we have been told that increased transparency with respect to the rationale behind common control combinations would be welcomed. This includes increased disclosure and/or transparency for the following areas:

- (i) qualitative information related to the underlying synergies or benefits expected to arise from the common control combination (for example, operational efficiencies and improved sustainability);
- (j) increased transparency surrounding related party transactions ("RPT") between the purchasing, selling and transferred entities; the involvement of the ultimate controlling party in the common control combination; and any other types of RPT that are related to the common control combination; and
- (k) fair values of the net assets of the transferred entity/business, including the fair value methodology, inputs, assumptions and details of the valuation expert.

Question 7

- (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?

Question targeted at preparers of financial statements

- (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?

Questions targeted at users of financial statements

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

8. Effects

In the absence of a standard, the HKICPA issued AG5 in 2005 so that preparers and users of financial statements would benefit from the basic principles and procedures of merger accounting when recognising a common control combination.

The HKICPA thought that issuing consistent, understandable and enforceable accounting guidance for common control combinations would improve the comparability of HKFRS financial information and simplify and reduce the costs of accounting for entities that encounter common control combinations.

This question seeks to understand whether respondents have benefited from the guidance in AG5; or incurred significant unexpected costs.

This question also aims to ensure that respondents have an opportunity to provide information on any additional matters that they think are relevant and that have not been addressed by any individual question in this RfI.

Question 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 share⁸?

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.

8 Paragraph 20 of AG5 sets out the accounting for earnings per share.

APPENDIX 1: Extracts of Accounting Guideline 5

The principles of AG5 are extracted below (paragraphs 4 to 9 of AG5):

Paragraph 4: This Accounting Guideline sets out the basic principles and procedures of merger accounting when recognising a common control combination. If there is any inconsistency between this Guideline and any Hong Kong Financial Reporting Standard or Interpretation (collectively referred to as “HKFRSs”), that Standard or Interpretation is to be followed. Certain HKFRSs may contain guidance or requirements that are relevant for the accounting for a common control combination using merger accounting. For example, HKAS 8 requires accounting policies to be applied consistently for similar transactions, HKAS 27 *Consolidated and Separate Financial Statements*⁹ addresses consolidation principles and the treatment of a disposal of a subsidiary and HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* addresses provisions for restructuring. Accordingly, an entity should apply that guidance or those requirements, instead of, or in addition to, the guidance set out in this Accounting Guideline when applying merger accounting.

Paragraph 5: It should be noted 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 this Accounting Guideline. In practice, these transactions may be accounted for by applying a principle similar to that for a reverse acquisition¹⁰.

Paragraph 6: The concept underlying the use of merger accounting to account for a common control combination is that no acquisition has occurred and there has been a continuation of the risks and benefits to the controlling party (or parties) that existed prior to the combination. Use of merger accounting recognises this by accounting for the combining entities or businesses as though the separate entities or businesses were continuing as before.

Paragraph 7: In applying merger accounting, financial statement items of the combining entities or businesses for the reporting period in which the common control combination occurs, and for any comparative periods disclosed, are included in the consolidated financial statements of the combined entity 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.

Paragraph 8: Where the combining entities or businesses include an entity or a business previously acquired from a third party, the financial statement items of such entity or business are only included in the consolidated financial statements of the combined entity from the date of the previous acquisition using the acquisition values recognised at that date.

9 HKFRS 10 *Consolidated financial statements* replaced HKAS 27 *Consolidated and Separate financial statements* on 1 January 2013

10 Reverse acquisitions are addressed in paragraphs B19 to B27 of HKFRS 3 *Business Combinations*. In particular, paragraph B19 states that the accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition and for all of the recognition and measurement principles in HKFRS 3 to apply. Paragraphs B7 to B12 of HKFRS 3 provide guidance on the definition of a business.

Paragraph 9: A single uniform set of accounting policies is adopted by the combined entity. Therefore, the combined entity recognises the assets, liabilities and equity of the combining entities or businesses at the carrying amounts in the consolidated financial statements of the controlling party or parties prior to the common control combination. If consolidated financial statements were not previously prepared by the controlling party or parties, the carrying amounts are included as if such consolidated financial statements had been prepared, including adjustments required for conforming the combined entity's accounting policies and applying those policies to all periods presented. These carrying amounts are referred to below as existing book values from the controlling parties' perspective. There is no recognition of any additional goodwill or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of the common control combination to the extent of the continuation of the controlling party or parties' interests. Similarly, in accordance with HKAS 27, the effects of all transactions between the combining entities or businesses, whether occurring before or after the combination, are eliminated in preparing the consolidated financial statements of the combined entity.

The procedures and practical effects of merger accounting for the net assets and liabilities of the combined entity are extracted below (paragraphs 10 to 13 of AG5):

Paragraph 10(a): The net assets of the combining entities or businesses are consolidated using the existing book values from the controlling parties' perspective (see paragraph 9). The assets and liabilities of the acquired entity or business should be recorded at the book values as stated in the financial statements of the controlling party (i.e. it will require recording of the fair value of the identifiable assets and liabilities of the acquired entity or business at the date of original acquisition from third parties by the controlling party, any remaining goodwill arising on the previous acquisition and minority interests recorded in the consolidated financial statements of the controlling party). 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.

Paragraph 10(b): no amount is recognised as consideration for goodwill or excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of common control combination, to the extent of the continuation of the controlling party or parties' interests; and

Paragraph 10(c): comparative amounts in the financial statements are presented using the principles as set out in paragraph 10(a) above 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.

Paragraph 11: The consolidated income statement includes the results of each of the combining entities or businesses from the earliest date presented (ie. including the comparative period) or since the date when the combining entities or businesses first came under the control of the controlling party or parties, where this is a shorter period, regardless of the date of the common control combination. The consolidated income statement also takes into account the profit or loss attributable to the minority interest recorded in the consolidated financial statements of the controlling party.

Paragraph 12: Expenditure incurred in relation to a common control combination that is to be accounted for by using merger accounting is recognised as an expense in the period in which it is incurred. Such expenditure includes professional fees, registration fees, costs of furnishing information to shareholders, and salaries and other expenses involved in achieving the common control combination. It also includes any costs or losses incurred in combining operations of the previously separate businesses.

Paragraph 13: Consolidation is performed in accordance with HKAS 27. The principal consolidation entries are as follows: (a) the effects of all transactions between the combining entities or businesses, whether occurring before or after the common control combination, are eliminated; and (b) since the combined entity will present one set of consolidated financial statements, a uniform set of accounting policies is adopted which may result in adjustments to the assets, liabilities and equity of the combining entities or businesses.

The accounting period covered by a newly formed parent is extracted below (paragraphs 14 to 15 of AG5):

Paragraph 14: A common control combination may be effected by setting up a new parent which acquires the issued shares or equity of the combining entities or businesses in exchange for the issue of its own shares. In such cases, the first accounting period of the new parent will frequently be a period of less than a year, ending on the balance sheet date chosen for the group. This will normally be the existing balance sheet date of one or more of the combining entities or businesses.

Paragraph 15: Frequently, the date of formation of the new parent will not coincide with the beginning or end of the group's accounting periods. Strictly, if the parent is a Hong Kong incorporated company, the Companies Ordinance requires the consolidated financial statements to cover the accounting period of the parent. It could be argued that this requirement prevents the disclosure of comparative information. In substance, however, where the combining entities or businesses are continuing to trade as before, but with a new legal parent, it is appropriate to prepare consolidated financial statements as if the parent had been in existence throughout the reported periods presented with a prominent footnote explaining the basis on which consolidated financial statements are prepared.

The example in the Appendix of AG5 is extracted below:

Background information

Entity P has a number of subsidiaries. This example looks at three subsidiaries – Entity X, Entity Y and Entity A.

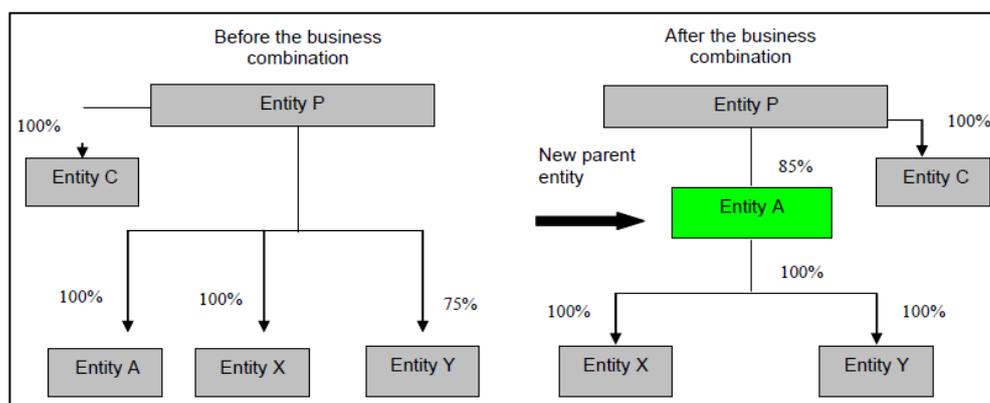
Entity P acquired 100% of Entity X for HK\$18,000 many years ago. At that time, Entity P recorded goodwill of HK\$3,000 and fair value of identifiable assets acquired of HK\$15,000 (which is equal to the then carrying amounts of the assets acquired).

Entity P set up Entity Y with a party outside the group, Shareholder S, many years ago. Entity P's cost of investment in Entity Y was HK\$15,000, being 75% of the share capital of Entity Y.

On 1 January 20X0, Entity P formed a new entity, Entity A, through share capital injection of HK\$10,000.

On 31 December 20X1, Entity A acquired 100% shareholdings in Entity X and Entity Y from Entity P and Shareholder S. In return, Entity A issued 7,000 and 3,000 ordinary shares with par value of HK\$1 each to Entity P and Shareholder S, respectively. Entity A, Entity X and Entity Y have financial year ends of 31 December. The fair values of assets and liabilities of Entity Y as at 31 December 20X1 are equal to their carrying values.

Ignore any tax effect arising from the business combination.



Analysis

As Entity A, Entity X and Entity Y are under the common control of Entity P before and after the business combination, the business combination is specifically excluded from the scope of HKFRS 3.

The directors of Entity A choose to account for the acquisition of the shareholdings in Entity X and Entity Y using the principles of merger accounting.

Under the principles of merger accounting, the assets and liabilities of Entity X and Entity Y are consolidated in the financial statements of Entity A using the existing book values as stated in the consolidated financial statements of Entity P immediately prior to the combination. This procedure requires recording of goodwill arising on the original acquisition of Entity X by Entity P and minority interests in Entity Y as stated in the consolidated financial statements of Entity P immediately prior to the combination.

There is no recognition of any additional goodwill or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of this combination.

The accounting for earnings per share are extracted below (paragraph 20 of AG5):

Paragraph 20: Ordinary shares issued as part of a common control combination which is accounted for using merger accounting are included in the calculation of the weighted average number of shares for all periods presented because the consolidated financial statements of the combined entity are prepared as if the combined entity had always existed. Therefore, the number of ordinary shares used for the calculation of basic earnings per share in a common control combination which is accounted for using merger accounting is the aggregate of the weighted average number of shares of the entity whose shares are outstanding after the combination.

APPENDIX 2: Disclosures under HKFRS 3 *Business Combinations*

A business combination must be accounted for by applying the acquisition method, unless certain criteria are met. HKFRS 3 *Business Combinations* sets out the principles under the acquisition method for recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. In general, measurement is at the acquisition date fair value with certain exceptions.

The disclosure items below are extracted from HKFRS 3. Disclosure items that mainly relate to goodwill, step acquisitions, and bargain purchases have not been included as they are not relevant to the principles of merger accounting.

Disclosures extracted from HKFRS 3:

- (a) the name and a description of the acquiree.
- (b) the acquisition date.
- (c) the percentage of voting equity interests acquired.
- (d) the primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree.
- (e) the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as:
 - (i) cash;
 - (ii) other tangible or intangible assets, including a business or subsidiary of the acquirer;
 - (iii) liabilities incurred, for example, a liability for contingent consideration; and
 - (iv) equity interests of the acquirer, including the number of instruments or interests issued or issuable and the method of determining measuring the fair value of those instruments or interests.
- (f) for contingent consideration arrangements and indemnification assets:
 - (i) the amount recognised as of the acquisition date;
 - (ii) a description of the arrangement and the basis for determining the amount of the payment; and
 - (iii) an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.
- (g) for acquired receivables:
 - (i) the fair value of the receivables;
 - (ii) the gross contractual amounts receivable; and
 - (iii) the best estimate at the acquisition date of the contractual cash flows not expected to be collected.

The disclosures shall be provided by major class of receivable, such as loans, direct finance leases and any other class of receivables.
- (h) the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed.
- (i) for each contingent liability recognised in accordance with paragraph 23, the information required in paragraph 85 of HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. If a contingent liability is not recognised because its fair value cannot be measured reliably, the acquirer shall disclose:
 - (i) the information required by paragraph 86 of HKAS 37; and
 - (ii) the reasons why the liability cannot be measured reliably.

- (j) for each business combination in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date:
 - (i) the amount of the non-controlling interest in the acquiree recognised at the acquisition date and the measurement basis for that amount; and
- (k) the following information:
 - (i) the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income for the reporting period; and
 - (ii) the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

If disclosure of any of the information required by this subparagraph is impracticable, the acquirer shall disclose that fact and explain why the disclosure is impracticable. This HKFRS uses the term 'impracticable' with the same meaning as in HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are authorised for issue, the acquirer shall disclose the information aforementioned in (a) to (k) unless the initial accounting for the business combination is incomplete at the time the financial statements are authorised for issue. In that situation, the acquirer shall describe which disclosures could not be made and the reasons why they cannot be made.

- (l) for each reporting period after the acquisition date until the entity collects, sells or otherwise loses the right to a contingent consideration asset, or until the entity settles a contingent consideration liability or the liability is cancelled or expires:
 - (i) any changes in the recognised amounts, including any differences arising upon settlement;
 - (ii) any changes in the range of outcomes (undiscounted) and the reasons for those changes; and
 - (iii) the valuation techniques and key model inputs used to measure contingent consideration.
- (m) for contingent liabilities recognised in a business combination, the acquirer shall disclose the information required by paragraphs 84 and 85 of HKAS 37 for each class of provision.
- (n) the amount and an explanation of any gain or loss recognised in the current reporting period that both:
 - (iv) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period; and
 - (v) is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.