



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

Feedback Statement

***Post-Implementation Review of Accounting Guideline 5
Merger Accounting for Common Control Combinations***

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Introduction

In August 2016 the Financial Reporting Standards Committee ("FRSC") of the Hong Kong Institute of Certified Public Accountants issued a Request for Information ("RFI") to conduct a post-implementation review ("PIR") of Accounting Guideline 5 *Merger Accounting for Common Control Combinations* ("AG 5"). The comment period closed on 2 December 2016.

The aim of the PIR was to proactively seek feedback from constituents on matters raised by the FRSC's Business Combinations and Reporting Entity Project Advisory Panel, comprising preparers, technical experts from accounting firms ("practitioners") and representatives of regulatory bodies in Hong Kong. The PIR also assessed the benefits, challenges and other effects of applying AG 5. This feedback statement serves as a formal record of the responses received from constituents and the key issues identified.

Overview of our PIR process

Based on the Advisory Panel's feedback, the areas on which the FRSC focused the PIR were:

- Scope and authority of AG 5
- Controlling party and carrying values
- Minority interests
- Comparatives
- Accounting for consideration paid
- Disclosures

There were two principal sources of obtaining feedback on the use of AG 5:

- Public consultation through RFI;
- Targeted outreach activities, including private meetings and roundtable discussions.

The comment letters received and targeted outreach meetings held in relation to the RFI is outlined in the Appendix. The letters and meeting summaries are available on [HKICPA's website](#).

Next steps

In 2017, the FRSC deliberated the feedback received on the RFI. Based on the information available, the FRSC decided to explore the following next steps:

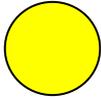
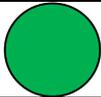
- Adding references of existing standards and a requirement to disclose who is the 'controlling party' to AG 5;

- Undertaking research on specific areas to better understand the issues and corresponding impact, and the underlying basis for certain concepts within AG 5 before deciding on further actions;
- Conducting further outreach with regulators and investors on some areas to better understand their needs and concerns;
- Explaining the concepts and the application of AG 5 through educational activities; and
- Sharing our findings and continuing discussions with the IASB staff to support their development of the International Accounting Standards Board's Business Combination under Common Control (BCUCC) project.

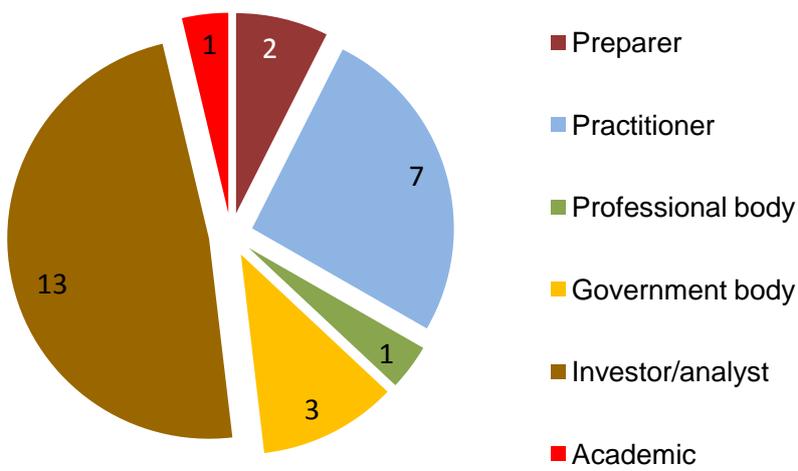
The FRSC also considered aligning its next steps with the IASB's own BCUCC project developments, depending on the progress of the respective projects.

Executive guide of our priorities and next steps

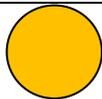
The table outlines the FRSC's proposed priority of issues, and a broad indication of what the priority means and possible next steps. Each focus area in this Feedback Statement contains a summary of issues and describes the priority in which they will be dealt with.

Priority	What this means	Possible next steps
	<p>Comments raised represent a general consensus with a wide reaching impact on all stakeholders. Considerable judgment or lack of clarity is involved that could have led to significant diversity in practice—some of which are not consistent with the principles of AG 5.</p> <p>Immediate action may be necessary.</p>	<p>AG 5 could be clarified by narrow-scope amendments to improve the use of AG 5 and to help investors better understand the impact of common control combinations.</p> <p>Public consultation on proposed narrow-scope amendments to AG 5 could be a next step.</p>
	<p>Comments raised indicate application issues, e.g. the procedures required by AG 5 are unclear or impractical.</p> <p>These issues need to be investigated further and could be dealt with locally.</p>	<p>Further outreach, education, research or public consultation on proposed amendments could be a next step.</p>
	<p>Comments raised indicate that these are areas of fundamental complexity.</p> <p>These issues need to be investigated further and might require deliberation with the IASB.</p>	<p>Further outreach or research may be required, and may result in field testing of proposals and consultation on proposed amendments.</p> <p>The IASB aims to publish a discussion paper on BCUCC in 2019.</p> <p>Our findings from further consultation, research or field testing will be shared with the IASB.</p>
	<p>Comments raised represent nice-to-have suggestions.</p>	<p>No action proposed at this stage.</p>

Feedback summary: Background of the respondents

Abstract of Question 1														
The Institute asked about the professional background of its respondents and their experience with accounting for common control combinations.														
Executive summary: Background of the respondents														
<p>The Institute received 8 written comment letters and held 10 targeted outreach and roundtable meetings in relation to the RFI (more respondent details are outlined in the Appendix). The chart below summarises the background of the respondents.</p>  <table border="1"><thead><tr><th>Background</th><th>Count</th></tr></thead><tbody><tr><td>Preparer</td><td>2</td></tr><tr><td>Practitioner</td><td>7</td></tr><tr><td>Professional body</td><td>1</td></tr><tr><td>Government body</td><td>3</td></tr><tr><td>Investor/analyst</td><td>13</td></tr><tr><td>Academic</td><td>1</td></tr></tbody></table> <p>All practitioner respondents have extensive experience in providing accounting advice on pre-IPO and post-IPO common control combinations.</p> <p>All preparer respondents are from Hong Kong listed companies that report under the HKFRS Framework. They have experience in accounting for common control combinations under AG 5.</p> <p>The remaining respondents have an understanding about the accounting requirements and practice for reporting common control combinations in Hong Kong.</p>	Background	Count	Preparer	2	Practitioner	7	Professional body	1	Government body	3	Investor/analyst	13	Academic	1
Background	Count													
Preparer	2													
Practitioner	7													
Professional body	1													
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Feedback summary: Scope and authority of AG 5

Abstract of Question 2		
The Institute asked what were the nature and purpose of the common control combination transactions that the respondents encountered, the accounting method selected and why.		
Executive summary: Scope and authority of AG 5		
Priority	Key messages	Possible next steps
	<p>Paragraph 2 of AG 5 defines common control combinations as 'combining entities or businesses'. At the same time, paragraph 5 of AG 5 infers that if there is no combination of two or more businesses, it should be scoped out of AG 5. An inconsistency in scope is noted.</p>	<p>Clarify the underlying objectives of the scope of AG 5 when it was developed.</p> <p>Add a basis for conclusions to explain whether combining entities that do not meet the definition of a business could apply AG 5.</p> <p>Discuss with stakeholders, including regulators, the implications of applying AG 5 to recapitalised combinations.</p>
	<p>AG 5 is not clear on what is considered 'non-transitory' common control—in particular, how long should the common control structure be held before and after the combination to be considered 'not transitory'?</p> <p>There is no guidance on 'transitory control' under HKFRS/IFRS. The basis for conclusions of the superseded IFRS 3 explained that the text 'control is not transitory' was included in the definition of a BCUCC to prevent structuring opportunities.</p>	<p>Discuss with stakeholders whether the issue is widespread in Hong Kong. If so, consider adding guidance and/or improve the education on how to identify the facts and circumstances that indicate a transitory transaction. If not, no further action should be taken as it may be akin to interpreting IFRS 3.</p>

Priority	Key messages	Possible next steps
	<p>HKAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> states that entities should apply accounting policies consistently for similar transactions, events and conditions.</p> <p>If an entity undertook a common control combination pre-IPO, it is unclear whether a common control combination post-IPO is a 'similar transaction or event' as the pre-IPO common control combination. This has resulted in diversity in applying HKAS 8 for common control combinations.</p> <p>Investors would like entities to apply sound and objective principles for when it is appropriate to account for common control combinations under acquisition method and predecessor method.</p>	<p>Consider adding indicators or guidance to AG 5 or the basis for conclusions on what is considered a similar transaction or event.</p> <p>Consider requiring an entity to disclose whether it views a pre- and post-IPO combinations as separate transactions or events and the reasons for those views.</p>

Detailed feedback summary

Respondents generally categorised common control transactions into two groups: those performed in preparation for an IPO (pre-IPO), and those performed by listed companies (post-IPO).

There were many reasons why common control transactions were undertaken. Typically, they are conducted for a future IPO; to improve operational and management efficiency; to implement efficient tax planning structures; to facilitate a disposal; and to expand or to rationalise group structures.

(a) Issue 1: Meeting the BCUCC definition

Common control transactions that occurred pre-IPO generally take the following form:

- A new holding company is created and inserted between the ultimate controlling party and the former holding company before the new holding company files for IPO. This scenario is explicitly scoped out of AG 5.

- An existing holding company or companies is/are inserted between the ultimate controlling party and various legal entities to establish a listing business. Many respondents considered this type of transaction to be outside the scope of AG 5.

In both cases, the consideration paid for the transferred company is usually not at arm's-length and does not involve cash.

Some practitioners noted that AG 5 does not apply to these cases. This is because it is unclear whether such cases meet the definition of a 'business' per HKFRS 3 *Business Combinations* and therefore fall in the scope of AG 5. Paragraph 2 of AG 5 defines common control combination as 'combining entities or businesses'. Paragraph 5 of AG 5 infers that if there is no combination of two 'businesses', it should be scoped out of AG 5.

As AG 5 is not clear, entities usually do not state whether AG 5 is applied, including in capital reorganisation cases. Instead, entities normally state that they have applied the 'principles of merger accounting', whereby the accounting treatment is similar to AG 5. The acquisition method under HKFRS 3 is generally not selected because respondents deemed capital reorganisations to lack commercial substance and fair valuing the transaction is considered meaningless and costly.

Furthermore, entities preparing for IPO are required to provide a historical track record for the Hong Kong listing requirements. Respondents commented that the 'principles of merger accounting' helped establish listing groups, particularly when a new company without historical financial record was created as the listing vehicle. This is because merger accounting requires comparatives to be restated as if the listing group had always existed.

(b) Issue 2: Control that is not transitory

Some respondents commented that AG 5 does not have guidance on what is considered 'not transitory' for the assessment of common control. They noted cases where a change in control occurred upon an IPO or after an IPO and there was diversity in determining whether those cases met the definition of common control that is not transitory.

One respondent commented that whether common control is 'transitory' should be assessed based on the total duration of common control before and after the combination, but not the duration of control only before or after the combination.

(c) Issue 3: Applying consistent policies for the accounting of pre-IPO and post-IPO combinations

Common control transactions undertaken by listed entities (i.e. post-IPO) typically involved:

- The exchange of direct subsidiaries under an ultimate holding company and under an intermediate company;
- The establishment of a new intermediate holding company within a group; or
- Acquisitions of subsidiaries from other related entities within the same group combined with a listing entity.

Typically, such post-IPO transactions are paid at fair value, and involve cash. Pre-IPO common control combination may have taken place in the past.

Respondents questioned whether entities that previously conducted a pre-IPO common control combination should be given a choice in selecting the accounting method for post-IPO common control combinations. Respondents expressed mixed views on this.

Entities should be given a policy choice

The underlying economic substance and/or the financial reporting framework of a combination under common control that took place for the purpose of IPO may be different from those that took place post-IPO. For example, IPO reports are special purpose financial reports/pro formas, and therefore the reporting requirements for the preparation of IPO reports should be distinguished from general purpose financial reports.

In these cases, some respondents think that entities should be allowed to apply the acquisition method for post-IPO common control combinations even if AG 5 or a predecessor method was applied for the accounting of pre-IPO common control combinations. These respondents believe that it is important to reflect the fair value of an acquired business, particularly where the transaction was at arm's-length and had similar commercial substance to a business combination with an unrelated third party.

Nevertheless, for cost-benefit reasons, some respondents think that entities should also be allowed to continue applying AG 5 for post-IPO combinations because:

- there may be no additional benefit in applying the acquisition method and remeasuring the acquired assets at fair value may only result in higher depreciation expenses;
- the costs associated with fair value measurement and allocating the purchase price to identifiable assets and liabilities under HKFRS 3 can outweigh the benefits;

- entities listed in both Mainland China and Hong Kong are required, under the Chinese Security Regulatory Commission's listing rules, to apply China Accounting Standards (CAS) which allows only merger accounting for certain common control combinations.

Entities should not be given a policy choice for post-IPO combinations

Some respondents believe there should not be a choice in accounting method once an entity has applied AG 5 or the 'principles of merger accounting' to pre-IPO common control transactions. This is because HKAS 8 requires an entity to apply the same accounting policy for similar transactions, and these respondents consider that pre-IPO and post-IPO combinations are similar transactions.

Investors emphasised the importance of having sound and objective principles for when it is appropriate to use the acquisition method and the predecessor method for pre-IPO and post-IPO common control combinations.

Feedback summary: Controlling party and carrying values

Abstract of Question 3

The Institute asked:

- whether the principles and procedures for merger accounting, as outlined in paragraphs 4 to 13 of AG 5 are clear, and if not, why.
- what were the main challenges in applying the principles and procedures of AG 5, and why.
- using Illustration 1, which entity is the 'controlling party' when applying AG 5, what were the considerations that led to that determination, and what were the main challenges faced.
- (For investors only) whether the possible diversity in identifying the 'controlling party' impaired their understanding of the financial statements.

Note: Unless otherwise indicated, all shareholdings are at 100%

Executive summary: Controlling party and carrying values		
Priority	Key messages	Possible next steps
	<p>AG 5 does not define controlling party. Respondents generally encountered challenges in identifying the controlling party without any guidance in AG 5. There are mixed views on who is the controlling party (ultimate, intermediate or immediate parent). Investors think that there should be some objective principles for identifying the controlling party in AG 5. They want to know who was identified as the controlling party, and why.</p>	<p>Consider adding indicators or guidance on the characteristics of a controlling party to AG 5 or the basis for conclusions.</p> <p>Consider requiring entities to disclose who is determined as the controlling party and why.</p>
	<p>There are practical issues in obtaining carrying values from controlling parties that are individuals or entities that do not prepare HKFRS/IFRS financial statements.</p>	<p>Consider adding to AG 5 a practical expedient that deals with such cases and providing education on the commonly accepted practices under these circumstances.</p>

Detailed feedback summary

Most respondents thought that the principles and procedures for merger accounting, as outlined in AG 5, are unclear. Nevertheless, one practitioner commented that AG 5 was sufficiently clear in providing principle-based guidance that facilitated the application of the principles to specific facts and circumstances.

AG 5 does not define controlling party. Therefore respondents commented that, identifying the controlling party is one of the main challenges. It is more challenging in cases where there are multiple layers of intermediate holding companies that recognise the acquired entity or business at different carrying values.

Under Illustration 1, a preparer considered that IP is the controlling party because the financial statements of the combined group are directly submitted to IP, rather than UP. Furthermore, for practical reasons, the ability to obtain the carrying values of S2 from IP's financial statements is often easier.

Some practitioners noted that UP is usually identified as the controlling party because UP is usually the majority shareholder and could provide more consistent carrying values regardless at what level the group prepares financial statements. Therefore these respondents think that the assets and liabilities of the transferred entity should be recorded at book values as stated in the financial statements of UP.

However, all practitioners commented that for various practical reasons, an intermediate or immediate parent may be identified as the controlling party, because:

- In private family businesses, the ultimate controlling parties are normally individuals and generally do not prepare financial statements. Therefore, the most readily available carrying values of the acquired entity are usually from the various legal entities involved in the combination. Identifying the controlling party requires significant judgment as these individuals may not have contractual agreements to specify how strategic, financial and operating decisions are made among themselves as they are family members.
- A state-owned enterprise or foreign entity may be the ultimate parent entity but they do not report under HKFRS/IFRS. In addition, one practitioner commented that the Chinese Implementation Guidance issued by the Ministry of Finance, China, specifies that the controlling party may not necessarily be the governing authority that ultimately holds the state-owned enterprises.
- There have been instances where allocating goodwill that relates to the acquired entity and is recognised at the ultimate parent level can be challenging. For example, under illustration 1, UP acquired IP after IP/P2 acquired S2. Goodwill arising from the acquisition of IP covers different entities/businesses within the IP subgroup. Allocating the goodwill that relates to S2 for the transfer to P3 requires significant management judgement.
- In cases where common control combinations are conducted for IPO purposes, the carrying values at the intermediate or immediate parent level could better meet the listing requirements. For example, under illustration 1, if P3 were to file for IPO immediately after UP acquired IP/P2, there would not be sufficient information about S2's carrying values from UP's perspective because UP did not control S2 for the whole track record period.

Investors expressed mixed views on who should be the controlling party. Some considered that the ultimate parent entity/individual, being the head of the group, is almost always the controlling party. Others are of the view that the immediate parent entity (especially those in a multi-layered group) has the highest stakes in its subsidiaries, and should therefore be the controlling party.

Investors observed that as AG 5 does not define controlling party, preparers could decide who is the controlling party based on which entity would provide the best carrying values to suit the group's targeted outcome. They therefore think that preparers should explain in the financial statements who is the controlling party and why. They also think that adding objective principles to AG 5 to guide such decisions would be helpful.

Feedback summary: Minority interests¹

Abstract of Question 4		
<p>The Institute asked:</p> <ul style="list-style-type: none"> whether the principles and example in AG 5 clearly articulate the accounting for minority interests, and why. what were the main challenges in accounting for minority interests in a common control combination under AG 5, and why. using Illustration 2, how respondents accounted for the change in S2's minority interests when applying AG 5, what were the considerations that led to that determination, and what were the main challenges. (For investors only) whether the possible diversity in accounting for minority interests impaired their understanding of the financial statements. 		
<p style="text-align: center;">ILLUSTRATION 2</p> <p style="text-align: center; font-size: small;">Note: Unless otherwise indicated, all shareholdings are at 100%.</p>		
Executive summary: Minority interests		
Priority	Key messages	Possible next steps
●	Accounting for changes in minority interest as a result of a common control combination is not well articulated in AG 5. The example in AG 5 is not realistic.	Consider a research on generally-accepted practices of accounting for minority interests and adding more commonly seen fact patterns to AG 5.

¹ 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 AG 5 text. The term 'non-controlling interest' is defined in HKFRS 10 *Consolidated Financial Statements*.

Priority	Key messages	Possible next steps
	<p>For various statutory or legal reasons, minority interests are often presented from the perspective of the reporting entity as at balance sheet date. Investors also support this presentation.</p>	<p>Consider establishing principles on how minority interests should be presented by analysing the appropriateness of accounting for minority interests (after a common control combination) from the perspective of the controlling party and the reporting entity.</p>

Detailed feedback summary

Most respondents found the example contained in AG 5 to be unclear, too simple and is not representative of real-life fact patterns. However, one practitioner commented that AG 5 was sufficiently clear in providing principle-based guidance, and the example adequately illustrated the application of the principles.

Most practitioners and preparers shared the following experience:

- The guidance in AG 5 shows an inconsistent accounting for minority interests between the prior period and the current period.
 - For prior year comparatives, the reporting entity (P3) reflects the minority interest from the controlling party's perspective (i.e. UP's or IP's perspective before the restructure in Illustration 2) in accordance with paragraphs 9 and 10(a) of AG 5. These respondents commented that presenting the historical minority interest from the controlling party's perspective is generally irrelevant to the reporting entity.
 - For the current year period, the reporting entity reflects the minority interest from its own perspective (i.e. P3's perspective after the restructure in Illustration 2) in accordance with paragraph 7 of AG 5. Using Illustration 2, minority interests would be zero as at the end of the current financial period.
- Following the guidance in AG 5, the reporting entity's financial statements (P3) shows a change in minority interest from prior period to current period, but that is not representative of the real situation because the reporting entity (P3) had no minority interest in the prior year. This may be a concern for entities undergoing an IPO as the financial statements do not provide a true representation of the reporting entity's perspective before the IPO.

Investors commented that minority interests that represent the legal structure of the reporting entity are more relevant and useful for their decision making.

Feedback summary: Comparatives

Abstract of Question 5		
The Institute asked what were the main challenges of presenting the financial statements as if no combination had occurred and as if there is a continuation of risks and benefits to the controlling party.		
Investors were asked if restatement of comparatives under AG 5 was useful.		
Executive summary: Comparatives		
Priority	Key messages	Possible next steps
	It is not clear why AG 5 requires the restatement of comparatives as it seems to contradict the principles of consolidation under HKFRS 10 <i>Consolidated Financial Statements</i> . The cost of restating comparatives is considered to outweigh the benefits because the restatement is simply pro-forma information, which is not useful in general purpose financial reports.	<p>Consider the appropriateness of restating comparatives for all common control combinations—should restatement be a requirement only for pre-IPO cases and in special purpose reports, not post-IPO cases? In the basis for conclusions of AG 5, explain the reason for requiring restatement.</p> <p>Reach out to regulators and investors to better understand their needs regarding comparative financial information.</p> <p>Research on other jurisdiction's requirements/practice on restating comparatives.</p>

Detailed feedback summary

Respondents commented that substantially all entities restated comparatives in pre-IPO and post-IPO common control combinations. However, respondents noted that the principles of AG 5 may conflict with the requirements of HKFRS 10. That is, HKFRS 10 requires consolidation when control is obtained by the reporting entity and prohibits

restatement of prior periods as if the reporting entity had always consolidated the acquired business.

Common issues that were encountered when restating comparatives include the following:

- If the acquired business was not a legal entity before the combination, instead it is the product of a few divisions of separate legal entities, there would be no clear comparative for the acquired business itself. To create comparatives for the acquired business, significant management judgment has been used to allocate the costs and determine the tax position.
- Some entities conduct common control combinations on a yearly basis. Restating comparatives each year may not provide useful information to users of financial statements as the performance trend of each new reporting entity changes every year.
- Management and directors of combining businesses change subsequent to common control combinations. The new management and directors have hesitated to approve financial statements with restated comparatives as they were not responsible for the past financial results of the combining businesses. Respondents also commented that restating comparatives also has a knock-on effect on the new reporting entity's performance measures and impacts the assessment of management performance.
- It is challenging to restate the comparatives without the use of hindsight in circumstances where individuals or foreign private entities are the controlling parties and do not prepare HKFRS consolidated financial statements.
- It is unclear whether the restatement of comparatives under the principles of AG 5 also applies to separate financial statements.

Others noted impacts to the business include:

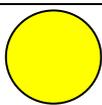
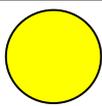
- A non-performing company may be incentivised to acquire a 'performing' related company to artificially reflect a better prior period group performance.
- Significant time cost in restating comparatives which may outweigh any benefits.

Generally, investors need prior period information that reflects a combination as if it had taken place in prior years. It would be difficult for trend analysis and forecasting of future performance without this information.

One investor commented that reconciliation between the previously published comparatives and restated comparatives would also be useful for transparency. Another investor suggested that given the significant challenges associated with restating comparatives, this requirement could be made optional (or voluntary). In general, preparers should know who are their users of financial reports and what information they

need. For example, in practice, investors would not invest in an entity that does not voluntarily provide information that its investors generally need. The same investor also suggested that there could be a threshold for when comparatives should be restated, for example, if the acquisition is material (i.e. larger than 10%-15% of net assets/profits).

Feedback summary: Accounting for the consideration paid

Abstract of Question 6		
The Institute asked what were the forms of consideration paid for common control combinations, and how the respondents accounted for the consideration in the current and comparative years.		
Executive summary: Accounting for the consideration paid		
Priority	Key messages	Possible next steps
	It is unclear how shares issued as consideration should be measured, particularly when the company is not publicly listed.	Consider analysing the connection between different forms of consideration and restatement of comparative figures.
	It is unclear why the different forms of consideration (for example, cash versus shares) would result in different accounting treatments, notably in the restatement of comparatives.	Consider adding to AG 5 references of applicable HKFRS for accounting the different forms of consideration. Consider investigating the rationale for the measurement of shares as consideration when AG 5 was developed.

Detailed feedback summary

The forms of consideration encountered by respondents typically included cash, shares, convertible bonds, or a combination of them.

Respondents noted that paragraph 10(c) of AG 5 requires entities to present comparative amounts in the financial statements as if the entities or businesses had been combined at the previous balance sheet date. This may imply that the consideration has to be recorded in the comparatives to reflect that the combination had always existed in prior periods. In this regard, respondents considered the principles of AG 5 conflicts the definition of financial liability in HKAS/IAS 32 *Financial Instruments: Presentation* as the 'consideration payable' did not exist prior to the common control combination.

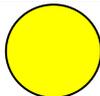
Respondents noted that entities typically recognised a financial liability in the period when the common control combination occurred if the consideration created a contractual obligation to settle by, for example, cash or convertible bonds. No liability is restated in the prior period. Instead, the corresponding balancing entry, i.e. the difference between the net asset of the acquired businesses and the liability (consideration), is usually recorded in equity to reflect that the combination had always existed in prior periods.

On the other hand, following the principles of AG 5, respondents noted that consideration in the form of shares is to be recorded as if the shares had always been issued. In the accounting for shares as consideration, respondents consider AG 5 to be unclear as to whether to record the shares at the net asset value of the acquired business, fair value of the shares transferred, or at cost. Accordingly, respondents noted there is diversity in the way shares as consideration is measured.

Respondents noted that when a listed company conducts a common control combination, the consideration normally reflects the 'fair value' of the acquired business in order to meet investor expectations.

Investors commented that they need information on the form of consideration and how the consideration was determined. This helps them understand whether the common control combination was 'fair', that is, at market price and at arm's-length.

Feedback summary: Disclosures

Abstract of Question 7		
The Institute asked what were the main challenges associated with the disclosure requirements in AG 5, and what could be the practical challenges in providing additional qualitative disclosures or disclosures similar to those required by HKFRS 3.		
Investors were asked how useful they have found the information presented in the financial statements of entities that performed common control combinations.		
Executive summary: Disclosures		
Priority	Key messages	Possible next steps
	Disclosures under AG 5 paragraphs 19(d) and 19(e) are onerous and at times not relevant.	Consider the rationale for requiring the information in paragraphs 19(d) and 19(e) when AG 5 was developed. If relevant, explain the rationale in the basis for conclusions of AG 5.

		Discuss with stakeholders, including regulators and investors about their information needs.
	It is unclear whether a third balance sheet should be presented when comparatives are restated.	The Institute's desktop research on common control combinations in Hong Kong confirms that a majority of listed entities restated comparatives and only some presented a third balance sheet. Consider whether to explicitly require a third balance sheet when comparatives are restated.

Detailed feedback summary

There were few responses to this question.

(a) Disclosure requirements in AG 5: objectives and clarity of requirements

A few respondents commented that they were not aware of challenges associated with the disclosure requirements in AG 5.

Practitioners found the information required under paragraphs 19(d) and 19(e) of AG 5 to be less relevant and meaningful to users of financial statements. In particular, respondents found paragraph 19(d) of AG 5 to be onerous given that HKFRS 3 or HKFRS 12 *Disclosures of Interests in Other Entities* do not require such information. It is also unclear what are the objectives of requiring a 'statement of adjustments to consolidated reserves' (paragraph 19(e) of AG 5).

In addition, respondents said that it is unclear under AG 5 whether the requirement to present a third balance sheet under HKAS 1 *Presentation of Financial Statements* is applicable when there is a retrospective restatement to comparatives.

(b) Feedback on additional disclosures set out in paragraphs 7(i) to 7(k) of the RFI

Respondents generally welcomed additional qualitative information about the common control combinations, but were also concerned that any additional information may be boilerplate disclosures.

(c) Feedback on similar disclosure requirements under HKFRS 3

Respondents (excluding investors) considered that disclosing similar information under HKFRS 3, such as the fair values of the acquired entity's or business's net assets, could be costly for preparers. A few respondents commented that these disclosures may not be relevant to some types of common control combinations.

A few respondents supported providing transparency on related party transactions, but they consider the information required under HKAS 24 *Related Party Disclosures* already meets this objective.

(d) Other recommended disclosures

As mentioned earlier, it is unclear which parent entity is the 'controlling party' under AG 5. Respondents requested this fact to be disclosed.

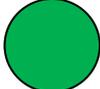
Practitioners suggested requesting information about the carrying values of the assets and liabilities of the acquired entity or business, including any goodwill allocated from the controlling party level and the basis of allocation.

Some investors considered it would be appropriate to recognise the assets and liabilities of the acquired entity or business based on the valuation provided to shareholders, if, the consideration reflects the market value of the acquired entity/business and the consideration was approved by the shareholders. Other investors observed that, in practice, disclosing the fair values of the acquired entity's or business's net assets could satisfy some minority shareholders, but not all minority shareholders.

One investor would like information on how the common control combination impacted the real cash flows of the entities involved. Such information would indicate whether there is a 'real' change in economic substance.

Feedback summary: Effects

Abstract of Question 8		
The Institute asked what were the effects of AG 5 since its issuance in 2005 (in the absence of a standard for common control combinations).		
The Institute also asked feedback on other matters.		
Executive summary: Effects		
Priority	Key messages	Possible next steps
	AG 5 refers to outdated text in HKFRS 3 and HKAS 27 <i>Consolidated and Separate Financial Statements</i> .	Update AG 5 for outdated text.

Priority	Key messages	Possible next steps
	<p>It is unclear when to use predecessor method versus acquisition method.</p>	<p>Develop a sound basis for when the acquisition method and predecessor method should apply, as a separate HKICPA project or in collaboration with other standard-setters including the IASB. Closely monitor the development of the IASB's BCUCC project.</p>
	<p>Request for the following guidance in relation to common control combinations:</p> <ul style="list-style-type: none"> • The accounting in separate financial statements; • The preparation of consolidated statement of cash flows; and • The calculation of earnings per share (EPS). 	<p>Consider a separate project that holistically deals with accounting issues in separate financial statements.</p> <p>Consider education sessions on the accounting for common control combinations that include the preparation of consolidated financial statements.</p>
	<p>Request for journal entries of a typical common control combination.</p>	<p>Such guidance would be overly prescriptive. No action proposed at this stage.</p>

Detailed feedback summary

(a) Benefits of AG 5

AG 5 provides practical accounting guidance and concepts of accounting for common control combinations under the merger accounting principles, which helped facilitate consistent accounting, presentation and disclosures.

Preparers found the merger accounting principles under AG 5 to be more cost friendly than the acquisition method under HKFRS 3, as fair value measurement is not required under AG 5.

(b) Unexpected costs of AG 5

Preparers commented that significant time and costs were incurred to obtain/prepare the necessary information for restating comparatives. Practitioners also commented that they incurred significant time and costs to audit the restated comparatives, particularly when

there were no separate books and records for the acquired businesses before the combination, and when the controlling party did not prepare HKFRS/IFRS consolidated financial statements.

(c) Other effects of AG 5

Respondents commented that common control combinations can be structured to achieve the targeted needs of the controlling party or the reporting entity. For example as AG 5 does not stipulate who is the 'controlling party', there is flexibility in using carrying values from a 'controlling party' that provides the best carrying values for the situation.

Respondents also commented that because AG 5 requires comparatives to be restated, the past financial information and position of an acquirer could reflect a better or worse result depending on the acquired entity's past financial information. This impacts the assessment of the acquirer's performance and management stewardship, and creates an incentive for non-performing companies to acquire 'performing' related companies to mask bad past performance.

Investors observed that there is also an incentive for a reporting entity to apply AG 5 to a common control combination if it plans to spin off the acquired entity at a later date at market value, which may then result in a higher gain in profit or loss. However, they are also concerned that a reporting entity is incentivised to apply the acquisition method under HKFRS 3 to artificially revalue the assets and liabilities of the acquired entity. Investors therefore think AG 5 should include sound and objective principles for when the merger accounting principles and HKFRS 3 should apply for common control combinations.

(d) Other feedback

Requests were also received on:

- Illustrative journal entries for a common control combination.
- Illustrative financial statements that reflect a common control combination that occurred during the year.
- Whether cash paid for the acquired common control entity should be presented as a financing or investing activity in consolidated statements of cash flows.
- The calculation and disclosures on EPS, as group reorganisations usually involve many capitalisation exercises.
- The accounting for common control combinations in separate financial statements.
- Deleting outdated references, for example, in paragraph 5 of AG 5: "In practice, these transactions may be accounted for by applying a principle similar to that for a reverse acquisition"; and throughout AG 5, replacing 'HKAS 27' with 'HKFRS 10' and 'minority interests' with 'non-controlling interests'. These texts have been revised in current accounting standards.

Appendix: Summary of comment letters and outreach events

Comment letters received

<u>Organisation</u>	<u>Capacity</u>
1. China Resource Enterprises, Limited	Preparer
2. Deloitte Hong Kong	Practitioner
3. Financial Services and Treasury Bureau	Government body
4. KPMG Hong Kong	Practitioner
5. Law Society of Hong Kong	Professional body
6. Official Receiver's Office	Government body
7. PwC Hong Kong	Practitioner
8. The DTC Association	Government body

Targeted outreach meetings

<u>Participant</u>	<u>Organisation</u>	<u>Capacity</u>
1. Alan Lok	CFA Institute	Experienced investor analyst
2. Not disclosed	Not disclosed	Practitioner
3. Not disclosed	Not disclosed	Preparer
4. Elza Yuen	PwC Hong Kong	Practitioner
5. Not disclosed	Not disclosed	Practitioner
6. Not disclosed	RSM Nelson Wheeler	Practitioner
7. Ghee Chong Peh	Capital Luck	Investor & experienced analyst
8. Lawrence Wong	GCE Consulting	Investor & Board advisor
9. Guochang Zhang	Hong Kong University	Academic

Roundtable meeting

<u>Participant</u>	<u>Capacity</u>
10 members of the Hong Kong Society of Financial Analysts	Institutional and private equity investors, and research analysts