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

Organismo Italiano di Contabilità

Business Combinations Under Common Control

Our experience in applying predecessor method in Hong Kong and Italy

IFASS Meeting
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Why we are looking at this

- BCUCC are scoped out of IFRS 3.
- Currently, BCUCC are commonly accounted for by some form of predecessor method; each jurisdiction has slight differences.
- IASB staff are exploring whether predecessor method could be a possible way to account for certain types of BCUCC.
- It is important that we learn from past experience on predecessor method if we were to continue applying it to some BCUCC.
- We are interested in your experience with predecessor method (challenges and benefits, etc) if it is applied in your jurisdiction.

Current situation in Hong Kong and Italy

Situation in Hong Kong

- BCUCC are common. From 2013-2015, at least 113 BCUCC took place among listed companies.
- No accounting standards but there is an accounting guideline for applying the predecessor method to BCUCC.
- A majority of Hong Kong companies applied predecessor method; others applied acquisition method in IFRS 3.
- In 2016 our post-implementation review of the accounting guideline found:
  - ✓ issues with the scope of the guideline; and
  - ✓ application issues [the focus of this presentation].

Refer to Feedback Statement for our complete findings.

Situation in Italy

- BCUCC are common.
- No accounting standards but there is some guidance issued by the Italian auditor association.
- In summary, according to this guidance BCUCC can be reported in the financial statements of the acquirer using:
  - ✓ Acquisition method under IFRS 3 if there is economic substance (ie a significant change in the cash flows generated by the entity); or
  - ✓ Predecessor method.

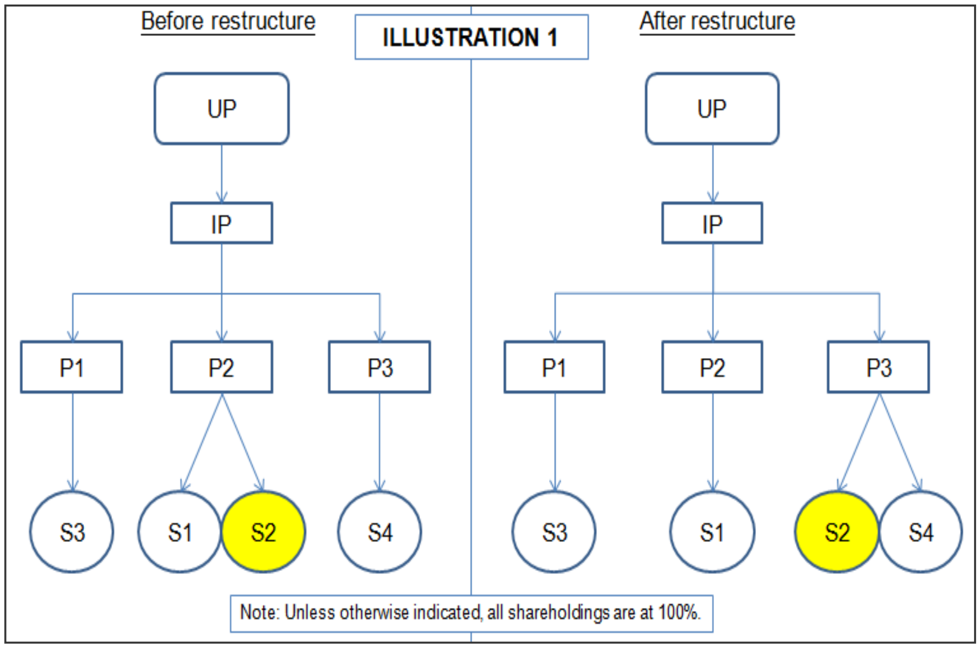
Overview of predecessor method

Underlying Concept	Scope	Accounting
No acquisition occurred from the group's perspective	Transaction that combines entities or businesses	Recognise the acquired assets and liabilities at the existing carrying values **from the controlling party's perspective**
Continuation of risks and benefits to the controlling party	All the parties are under 'common control'	Restate **comparatives**
	Control is 'not transitory'	Recognise in reserve the difference between consideration and book value exchanged

Top 3 application issues with predecessor method

Issue 1: Controlling party & carrying values

- Entities recognise the transferred entity at the existing carrying values from **the controlling party perspective**.
- It is not clear who is the controlling party.



Background

- IP/P2 acquired S2 from a third party. UP acquired IP/P2 from a third party. Acquisition method under IFRS 3 was applied in both combinations.
- S2 had different carrying values in both consolidated financial statements of IP/P2 and UP.
- After several years, P3 acquired S2 from P2.

Question: Who is the controlling party? UP or IP?

Issue 1: Controlling party & carrying values

Ultimate parent (UP) is usually identified as the controlling party because:

- it is usually the majority shareholder; and
- it provides consistent carrying values in most cases.

However, there are practical difficulties:

- UP can be an individual that does not prepare financial statements.
- UP can be a foreign entity that does not report under IFRS.
- Difficult to allocate purchased goodwill recognised at the UP level that relates to the transferred entity.

IP may be identified as the controlling party for practical reasons.

Issue 2: Should comparatives be restated

View 1

- Comparatives should be restated as if the entities had always been combined from the beginning of the earliest period presented because there is no change in control from UP's perspective (the underlying concept).

- The income statement should reflect the results of the combining entities for the full year, irrespective of when the BCUCC takes place.

View 2

- No restatement of comparatives because IFRS 10 requires a parent’s consolidated financial statements to only include the income and expenses of a subsidiary from the acquisition date.

- IFRS 10 does not exclude BCUCC from its scope.

Issue 2: Should comparatives be restated

Practical difficulties are also identified:

- Significant time cost.
- Potential incentives to fabricate a BCUCC to boost short-term performance.
- Frequent BCUCC may distort trend analysis of the reporting entity's core business performance.
- Management hesitation to approve financial results with restated comparatives that they were not responsible for.

Question: what is your view?

Issue 3: Non-controlling interests

Should NCI be reflected from the perspective of the 'controlling party' level or the reporting entity level?

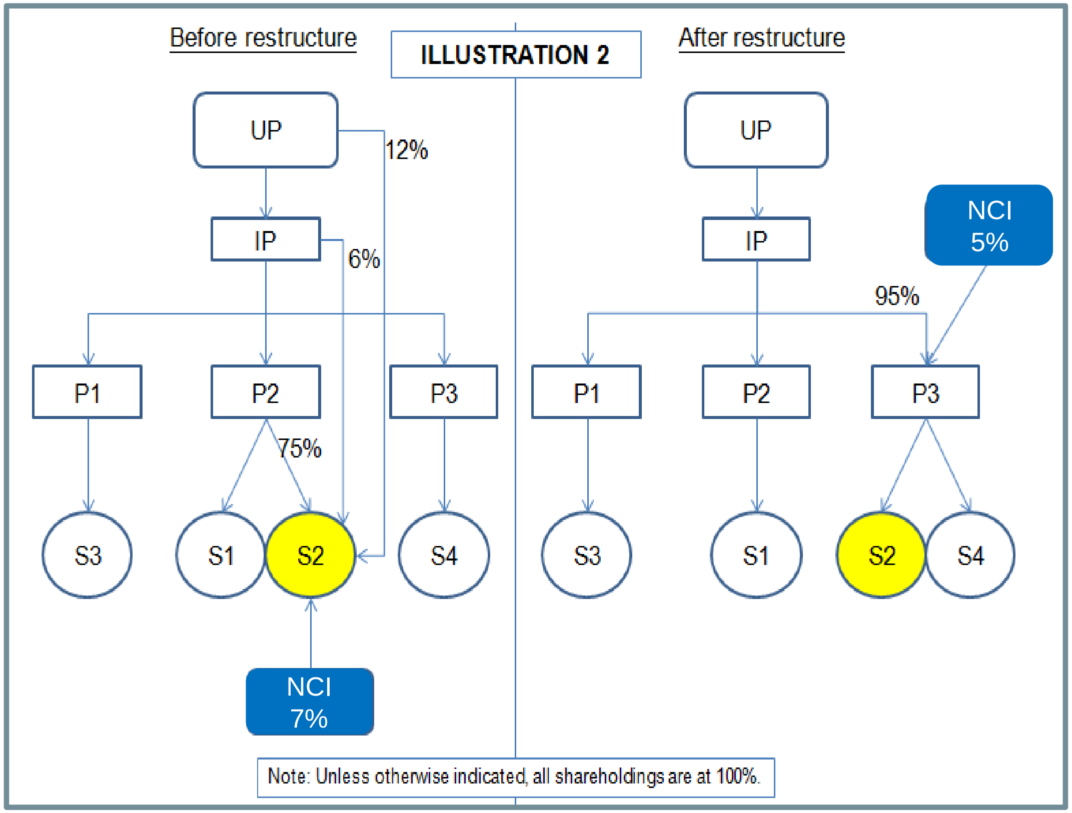
View 1

- Accounting for NCI should be consistent with the underlying concept, i.e. from the perspective of the 'controlling party'.

View 2

- NCI that reflects the legal structure of the reporting entity are more relevant and useful for decision making.

Issue 3: Non-controlling interests



Background

- UP, IP and P2 transferred their shares in S2 to P3.
- P3 issued 5% of its own shares to NCI in return for NCI's 7% shares in S2.
- P3 obtained 100% shareholding in S2 after restructure.

Question:

In P3's consolidated financial statements, what should be the NCI% of S2 in the current and prior periods using predecessor method?

Discussion points

In your jurisdiction:

- Is predecessor method applied in the accounting for BCUCC?
- Have you encountered application issues as identified in Hong Kong and Italy?
- Are there other application issues?