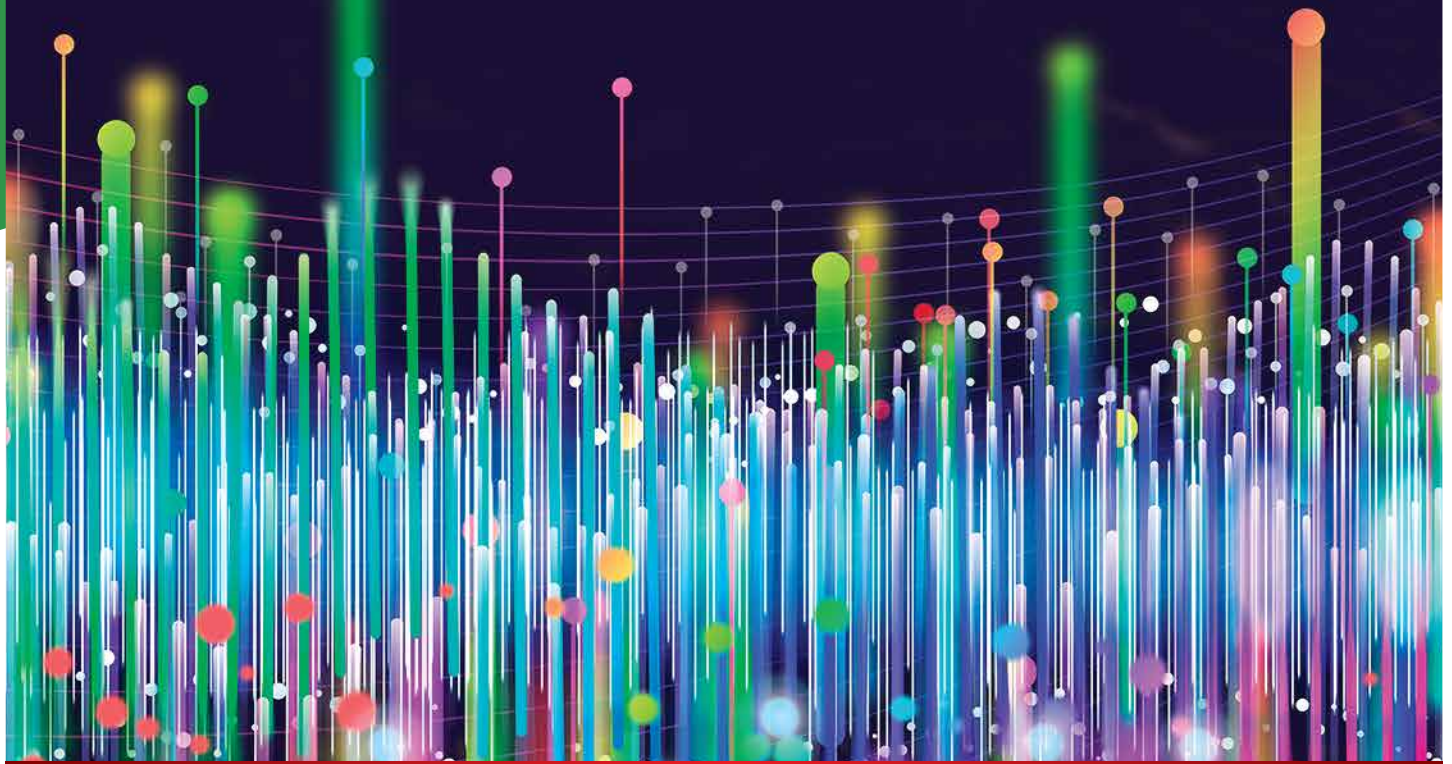


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# STANDARD SETTING

## Common control combinations - How they were reported in Hong Kong



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

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# Introduction

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## Background

In Hong Kong, many listed companies have concentrated ownerships. A large number of Hong Kong incorporated companies are under family control, while many Chinese enterprises listed in Hong Kong are either under family control or controlled by state-owned enterprises (SOEs). These particular ownership structures therefore drive a high prevalence of common control combinations<sup>1</sup> among listed companies in Hong Kong.

Currently there are no specific requirements in International Financial Reporting Standards (IFRS) for common control combinations and entities applying IFRS account for them in different ways. At the time of publication, only business combinations between entities or businesses that are not under common control have specific IFRS requirements. IFRS 3 *Business Combinations* and its equivalent Hong Kong Financial Reporting Standard (HKFRS) 3 *Business Combinations* require all business combinations not under common control to be consistently accounted for applying the acquisition method.

To fill this void, in 2005, the Hong Kong Institute of Certified Public Accountants (the Institute) issued Accounting Guideline 5 *Merger Accounting for Common Control Combinations* (AG 5) which sets out the principles to account for common control combinations. The method applied under AG 5 is often referred to as the 'predecessor method'. AG 5 is not mandatory but is persuasive in intent.

From the background research undertaken by the Standard Setting Department (SSD) of the Institute, it has been observed that most companies use a form of the predecessor method, and these companies also generally apply AG 5. However other common control combinations in Hong Kong are reported using the acquisition method. As each method results in very different financial information, the common control combinations are not comparable. The appendix provides a summary of differences between the predecessor method and the acquisition method.

In light of this finding, SSD sets out to study and document the ways in which Hong Kong listed companies report common control combinations.

## Objectives

The main objectives of this study were to understand:

- a) how common control combinations in Hong Kong have been reported and whether the accounting method was influenced by specific characteristics of the combination; and
- b) when the predecessor method was applied, the accounting practice and the information disclosed.

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1 Paragraph B1 of HKFRS 3 defines common control combinations as business combinations in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combinations.

Findings from the study are expected to provide useful information for the Institute's Post-implementation Review (PIR) of AG 5 and help assess whether improvements to AG 5 are necessary. The findings are also expected to provide useful input for the ongoing International Accounting Standards Board's (IASB) research project on Business Combinations under Common Control, especially in identifying characteristics of common control combinations and whether these characteristics should be considered in determining the accounting method for common control combinations. Users of financial statements may learn about the patterns of common control combinations and how the accounting outcomes impact investment decision-making.

## Key findings

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The key findings from our review include:

- a) The predecessor method is commonly used to account for common control combinations undertaken by Hong Kong listed entities. This is likely due to the fact that most companies that undertook common control combinations were Chinese companies and they were required or influenced by their controlling parties (normally the SOEs) to apply the predecessor method under the China Accounting Standards for Business Enterprises ('CASBE').
- b) When the predecessor method was applied, entities applied different forms of predecessor method and the type of information disclosed (e.g. who was identified as the controlling party and whether comparative information was restated) was not consistent.
- c) Some entities selected the acquisition method to report common control combinations under the following circumstances:
  - The purpose of the transaction is obtain synergies or diversify the acquirer's business.
  - The consideration approximates the market value of the acquired business – a fair exchange.
  - The controlling party exercises de facto control over the acquirer and the acquired business. That is, the controlling party holds less than 50% of the equity interest but nonetheless exercises control over the acquirer and the acquired business.

SSD thinks there might be an indication that these common control combinations have similar or the same substance as business combinations between entities that are not under common control and therefore, are accounted for using the same method.

## Next steps

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To better understand the characteristics of common control combinations, and whether and how they affect the choice of accounting method, SSD plans to carry out further analysis to determine which characteristics of common control combinations should be considered when evaluating the substance of a BCUCC. This analysis will include applying the characteristics identified from this study to evaluate the substance of commonly-seen fact pattern in Hong Kong and assess whether those characteristics would be useful in determining the substance of the combinations and hence the accounting for BCUCC. Findings from our further studies will be shared with the IASB project team.

## Scope and methodology of the study

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### Sample methodology

SSD reviewed information<sup>2</sup> available from the Hong Kong Stock Exchange (HKEx) for the years 2013 to 2015 (the study period) and selected 880 listed entities as the study sample. These 880 listed companies were selected as they meet one or more of the following criteria:

- a) Companies had undertaken a Notifiable Transaction<sup>3</sup> which constituted a reorganization, merger or business combination.
- b) Sizable companies, i.e. the top 50 largest Main Board listed companies in terms of market capitalization, because they tend to undertake group restructurings.
- c) Small- to mid-sized companies that tend to grow through mergers and acquisitions, i.e. entities listed on the GEM Board.
- d) Companies with People's Republic of China (PRC) SOE influence and have undergone government-initiated structural reform (the SOE reform), i.e. H-share issuers.

These 880 companies collectively represented 75% of the market capitalization of companies listed in Hong Kong.

Type of Company	Number of companies	Market capitalization
Locally based <i>(Incorporated in Hong Kong or Macau)</i>	303	23.6%
H-share <i>(Incorporated in PRC and controlled by PRC SOEs or individuals)</i>	229	15.1%
Red chip <i>(Incorporated outside PRC and controlled by PRC SOEs)</i>	82	14.9%
Mainland private enterprise <i>(Incorporated outside PRC and controlled by PRC private enterprises or individuals)</i>	248	13.2%
Others <i>(Incorporated outside Hong Kong, Macau and PRC)</i>	18	8.3%
<b>Total</b>	<b>880</b>	<b>75.1%</b>

To identify companies which had undertaken common control combinations during the study period, SSD:

- a) filtered the companies for the explicit disclosure of 'common control'.
- b) Where there were no 'common control' disclosures:
  - i) filtered for connected transactions<sup>4</sup>; and

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2 Information disclosed in annual reports, circulars or announcements issued to shareholders as required under HKEx listing rules.

3 A transaction classified as a share transaction, discloseable transaction, major transaction, very substantial disposal, very substantial acquisition or reverse takeover under HKEx listing rules. Depending on the size of the Notifiable Transaction, a circular or announcement is required to be issued by the listed companies.

4 Rule 14A.07 of the Main Board Listing Rules states that connected transactions are transactions carried out by connected persons. A "connected person" is: (1) a director, chief executive or substantial shareholder of the listed issuer or any of its subsidiaries; (2) a person who was a director of the listed issuer or any of its subsidiaries in the last 12 months; (3) a supervisor of a PRC issuer or any of its subsidiaries; (4) an associate of any of the above persons; (5) a connected subsidiary; or (6) a person deemed to be connected by the HKEx. Depending on the size of the connected transaction, a circular or announcement is required to be issued.

- ii) from the companies identified in step (b)(i), reviewed the group structure to see if the acquirer and the acquired business were both under common control before and after the acquisition.

There may be cases where a common parent holds less than 50% of equity interest but nonetheless exercises de facto control over the acquirer or the acquired business both before and after the combination. Therefore, acquisitions that met the following criteria<sup>5</sup> were also deemed to be common control combinations under our study:

- Where the controlling party is a PRC SOE, it held at least 30% equity interest in the acquirer and the acquired business; or
- Where the controlling party is a private company or an individual, it held at least 40% equity interest in the acquirer and the acquired business.

### Identified common control combinations by type of company and industry

93 companies reported a total of 113 common control combinations during the study period.

Type of Company	Number of companies	Number of companies which undertook common control combinations	Percentage
Locally based	303	20	7%
H-share	229	57	25%
Red chip	82	7	9%
Mainland private enterprise	248	6	2%
Others	18	3	17%
<b>Total</b>	<b>880</b>	<b>93</b>	<b>11%</b>

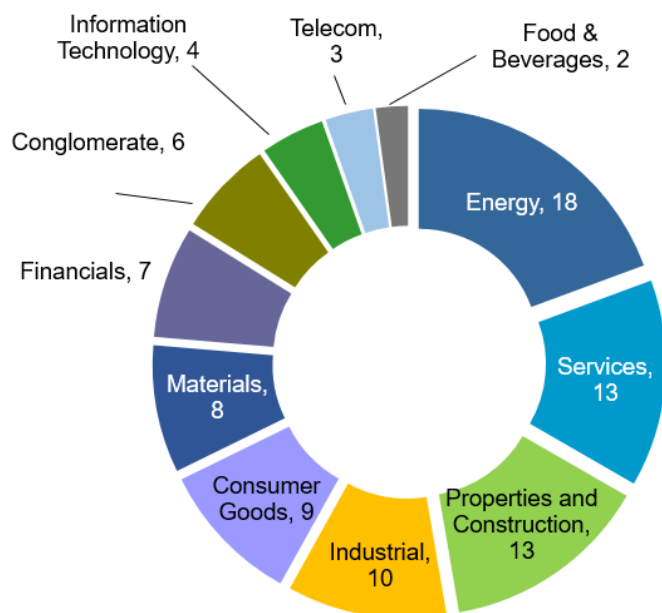
A higher prevalence of common control combinations was observed among H-share companies, which may be attributable to the SOE reforms during the study period.

We also analyzed these 93 listed companies by industry to understand whether common control combinations were more common in some industries and identify the main drivers for common control combinations in those industries.

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5 The percentages used in the criteria were chosen in order to capture most of these common control combinations based on advice from SSD's Business Combinations and Reporting Entity advisory panel.

These 93 listed companies were from the following industries:



Common control combinations were more prevalent in the energy industry over the study period. Out of the 18 energy companies that undertook common control combinations, 15 are either H-share or Red Chip companies with the majority of them being coal and power companies ultimately controlled by PRC SOEs. Common control combinations undertaken by these SOEs were believed to be driven by the reform plan issued by the PRC State Council which sought to improve efficiency in the power sector, increase the use of renewable energy and revamp the electricity pricing system.<sup>6</sup> Although only 3 telecommunication companies undertook common control combinations, these companies constitute about 7% of the total Hong Kong market capitalization. The common control combinations among the telecommunication companies were driven by restructuring plans of China's biggest wireless carriers to pool assets and reduce duplication.<sup>7</sup>

## How common control combinations were reported and possible influences

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This section focuses on how the identified common control combinations in Hong Kong were reported and whether the accounting method used was influenced by the specific characteristics of the combinations.

### Methods used by companies in the sample

The method of measuring and recognising a business when it is acquired by a related entity under the common control of the same parent company has a significant impact on the acquirer's financial statements. The methods commonly adopted in practice are the acquisition method and the predecessor method.

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6 *China Daily*, 2015-03-26, *Reform will power changes across electricity industry*

[http://www.chinadaily.com.cn/business/2015-03/26/content\\_19912740.htm](http://www.chinadaily.com.cn/business/2015-03/26/content_19912740.htm)

*Deal Law Wire*, 2015-10-21, *M&A activity is booming in Asia's renewable energy industry*

<https://www.deallawwire.com/2015/10/21/ma-activity-is-booming-in-asias-renewable-energy-market/>

7 *Live mint*, 2015-10-15, *China telecom industry restructure pushes China Mobile up*

<https://www.livemint.com/Companies/1VaMmT3SK6UMiw7eEtLZOK/China-telecom-industry-restructure-pushes-China-Mobile-up.html>

Of the 113 common control combinations identified in this study, 88% applied the predecessor method. The following table summarizes our analysis by method.

Type of Company	Accounting standard adopted	Number of combinations	
		Under the predecessor method	Under the acquisition method
H-share	HKFRS	12	-
	IFRS	27	4
	CASBE	12	-
	HKFRS and CASBE	1 <sup>8</sup>	-
	IFRS and CASBE	1 <sup>8</sup>	1
	<b>Subtotal</b>	<b>53</b>	<b>5</b>
Red chip	HKFRS	9	-
	IFRS	1	-
	<b>Subtotal</b>	<b>10</b>	<b>-</b>
Mainland private enterprise	HKFRS	10	-
	<b>Subtotal</b>	<b>10</b>	<b>-</b>
Locally based	HKFRS	22	7
	IFRS	-	1
	<b>Subtotal</b>	<b>22</b>	<b>8</b>
Others	HKFRS	3	-
	IFRS	2	-
	<b>Subtotal</b>	<b>5</b>	<b>-</b>
<b>Total</b>		<b>100</b>	<b>13</b>

Most companies applied the predecessor method to common control combinations. Possible reasons include:

- a) Some Chinese companies (H-shares, Red Chips and Mainland private enterprises) adopted CASBE, which requires the application of the predecessor method for certain common control combinations.
- b) Chinese companies that adopted HKFRS or IFRS may choose to apply the predecessor method to have a consistent accounting policy with their controlling parties in the PRC. Only one H-share company chose the acquisition method for its financial statements prepared under IFRS while applying the predecessor method for its financial statements prepared under CASBE. This company used the acquisition method for all common control combinations in the financial statements prepared under IFRS but did not state its reasons for doing so.
- c) Some Hong Kong based companies followed the 'principles of merger accounting' as set out in AG 5 and therefore applied the predecessor method.

The remaining 12% of common control combinations in this study were accounted for under the acquisition method.

<sup>8</sup> Both companies presented two sets of financial statements in their annual reports. One set was prepared under CASBE and the other set was prepared under HKFRS or IFRS. Predecessor method was applied to both sets of financial statements.



## Common characteristics of the combinations

To understand if there were other observable trends that might influence companies in choosing the method for accounting, SSD examined the disclosures from circulars and annual reports to determine the following characteristics of the combinations: (a) ownership structure; (b) purpose of combination; and (c) form and measurement of the consideration.

### (a) Ownership structures

SSD reviewed the group structures of the companies, in particular the percentage of ownership of the controlling party over the acquirer and the acquired businesses before and after the common control combinations.

The predecessor method was generally applied to combinations where the acquirer and the acquired businesses were clearly under common control before and after the combinations (i.e. more than 50% of the acquirer and the acquired businesses were held by the controlling party). Combinations that were reported using the acquisition method were more likely to occur in instances of de facto control — i.e. less than 50% of the acquirer or acquired businesses were held by the controlling party.

% of ownership held by the controlling party over the acquirer and / or the acquired businesses	Number of combinations	
	Under the predecessor method	Under the acquisition method
Over 50%	93	7
30% to 50%	7	6
<b>Total</b>	<b>100</b>	<b>13</b>

### (b) Purpose of the combinations

As noted in the above 'scope and methodology' section, common control combinations undertaken by H-share or Red Chip companies were mainly driven by PRC SOE reforms. To understand further how this and other factors may influence the choice of accounting for BCUCC, SSD considered the following questions:

- What was the purpose of the entity acquiring another business under the common control of the controlling party?
- Were there incentives for the acquirer to choose a different accounting method to achieve a specific accounting outcome?

The following table summarizes the purpose of the identified common control combinations.

Purpose of transaction	Number of combinations	
	Under the predecessor method	Under the acquisition method
Streamline operation <i>(to improve the efficiency of the group structure)</i>	36	3
Synergy <i>(for increased income, positive future cash flow or other added benefits to the acquirer)</i>	21	5
Access to particular intangible assets	13	1

Purpose of transaction	Number of combinations	
	Under the predecessor method	Under the acquisition method
Access to property or land	6	1
Diversification <i>(to diversify the corporate portfolio or the risks of the acquirer)</i>	1	3
Avoid delisting <i>(to prevent the acquirer from being delisted from the Shanghai Stock Exchange)</i>	1	-
Not specified	22	-
<b>Total</b>	<b>100</b>	<b>13</b>

Common control combinations were carried out for many reasons, mainly to improve operational efficiencies, to achieve new synergies, and for access to specific assets. Combinations to improve operational efficiencies within the group were generally directed by the controlling party. However, combinations for reasons such as achieving new synergies and access to specific assets were sometimes initiated between the combining entities (i.e. not directed by the controlling party) and these are also common reasons for undertaking business combinations between entities that are not under common control.

The predecessor method was most commonly applied to common control combinations for the purpose of streamlining operation. This is likely to be because from the perspective of the controlling party, these combinations were merely group restructuring — moving companies within the group to achieve a particular legal group structure and/or operational efficiency to the group as a whole. In other words, they did not aim to change the economic position of the acquirer. This is different from a business combination between entities that are not under common control.

The acquisition method was commonly adopted for combinations that were conducted to achieve some sort of synergistic effect to the acquirer, for example, increasing its future income or cash flow. This is consistent with the underlying concept of the acquisition method that the combination is expected to bring in economic changes to the acquirer.

The purpose of 22 common control combinations was not disclosed. These combinations were not significant to the acquirer — in each case the underlying assets of the acquired business represented less than 0.1% of the total assets of the acquirer and as such more information about the transaction was not required under the HKEx listing rules.

*(c) Form and measurement of consideration*

The following tables outline how consideration was determined and what form of consideration was paid for the identified common control combinations.

### Common control combinations applying the predecessor method

Form of consideration	Measurement of consideration					
	Market value of	Adjusted NAV <sup>9</sup> of	Unadjusted NAV <sup>10</sup> of	Nominal	Not specified	Total
	the acquired business					
Cash	35	2	3	5	12	57
Shares	8	-	3	7	3	21
Mixed payment <sup>11</sup>	11	4	-	-	-	15
Not specified	-	-	-	-	7	7
<b>Total</b>	<b>54</b>	<b>6</b>	<b>6</b>	<b>12</b>	<b>22</b>	<b>100</b>

### Common control combinations applying acquisition method

Form of consideration	Measurement of consideration		
	Market value of the acquired business	Adjusted NAV of the acquired business	Total
Cash	6	-	6
Convertible bond	1	1	2
Shares	1	1	2
Mixed payment <sup>11</sup>	1	2	3
<b>Total</b>	<b>9</b>	<b>4</b>	<b>13</b>

The acquisition method was only applied to combinations that reflected a fair exchange — consideration was either at the market value of the acquired businesses or approximated the market value of the underlying assets. Combinations that were transacted at nominal amounts or book values of the acquired business all applied the predecessor method. This indicates that a fair exchange is one of the factors that affects the choice of accounting method for common control combinations.

Even though the predecessor method does not necessitate fair valuation of the acquired business, more than half of the common control combinations applying the predecessor method in this study either disclosed that the acquired businesses was purchased at its market value or was purchased at its net book value with particular assets adjusted to market value. However, the level of detail (e.g. the methodologies and assumptions) regarding how the market value was determined varied between combinations.

22 combinations accounted for under the predecessor method did not disclose how the consideration was determined. Again, it appears that those combinations are insignificant to the acquirers. Companies are not required to disclose information about combinations that are not deemed significant under the HKEx listing rules.

Common control combinations in Hong Kong were settled in many ways — in cash, shares or a combination of both. The form of consideration does not seem to be a factor that affects the choice of the accounting method.

9 The acquired business is measured at the net book value with some particular assets adjusted to market value.

10 The acquired business is measured at the net book value with no adjustment.

11 A combination of cash, convertible bond or newly issued ordinary shares.

## Application of the predecessor method

This section focuses on how companies applied the predecessor method. We analysed the identified common control combinations accounted for under the predecessor method to determine:

- which accounting framework was used in applying the predecessor method;
- who was identified as the controlling party; and
- whether comparative information was restated.

### Which accounting framework was used in applying the predecessor method

The table below outlines the accounting framework the financial statements were prepared under and whether AG 5 or another form of predecessor method was applied.

Accounting Framework	Type of company	AG 5	CASBE	Not specified	Total
HKFRS	Locally based	18	-	4	22
	H-share	9	-	3	12
	Red chip	6	-	3	9
	Mainland private enterprise	7	-	3	10
	Others	3	-	-	3
Subtotal		43	-	13	56
IFRS	Locally based	-	-	-	-
	H-share	5	-	22	27
	Red chip	-	-	1	1
	Mainland private enterprise	-	-	-	-
	Others	-	-	2	2
Subtotal		5	-	25	30
CASBE	Locally based	-	-	-	-
	H-share	-	12	-	12
	Red chip	-	-	-	-
	Mainland private enterprise	-	-	-	-
	Others	-	-	-	-
Subtotal		-	12	-	12
<b>Total</b>		<b>48</b>	<b>12</b>	<b>38</b>	<b>98*</b>

Note:

\* The table above does not include two H-share companies which are dually-listed in China and Hong Kong and presented two sets of financial statements in their annual reports. Both companies presented one set of financial statements under CASBE. One of the companies prepared a second set of financial statements under HKFRS and applied AG 5. The other company prepared a second set of financial statements under IFRS and did not specify which predecessor method was applied.

A majority of the companies that reported under the HKFRS framework stated explicitly that they applied the predecessor method under AG 5 to account for common control combinations. Most companies that reported under the IFRS framework did not specify whether AG 5 or another predecessor method was applied, but explained in the accounting policy that the common control combinations were accounted for using the existing carrying values of the transferred businesses. Companies that reported under the CASBE framework specified that they applied the predecessor method under CASBE.

## Who was identified as the controlling party

The concept underlying the use of the predecessor method for common control combinations is that from the perspective of the controlling party, no acquisition has occurred. Following this concept, the acquirer recognises the assets and liabilities of the acquired business at the book values from the controlling party's perspective. There are mixed views held by stakeholders in Hong Kong as to who is the controlling party (ultimate, intermediate or immediate parent) in the context of common control combinations. Many stakeholders think that there should be criteria for determining the controlling party to avoid allowing a choice of predecessor carrying values that could provide more or less favourable values to the acquirer. Stakeholders also commented that the identity of the controlling party should be disclosed in the financial statements.

The table below summarizes the identity of the controlling party of the identified common control combinations.

	Number of combinations					
	HK based	H-share	Red chip	Mainland private enterprise	Other	Total
<b>Who is the controlling party?</b>						
PRC SOE	-	45	4	-	-	49
Private company in PRC	4	3	2	7	2	18
Private company offshore <sup>12</sup>	9	-	-	-	2	11
Private company in HK	2	-	2	-	-	4
Listed company in PRC	-	-	-	1	-	1
Listed company in Singapore	1	-	-	-	-	1
Individual	4	-	-	-	-	4
Not specified	2	5	2	2	1	12
<b>Total</b>	<b>22</b>	<b>53</b>	<b>10</b>	<b>10</b>	<b>5</b>	<b>100</b>
<b>Which level is the controlling party?</b>						
Ultimate parent	10	29	5	4	2	50
Intermediate or immediate parent	10	19	3	4	2	38
Not specified	2	5	2	2	1	12
<b>Total</b>	<b>22</b>	<b>53</b>	<b>10</b>	<b>10</b>	<b>5</b>	<b>100</b>

Most annual reports, circulars, or both described the name and/or the background of the controlling party; but not on how the controlling party was determined.

<sup>12</sup> Companies incorporated in off-shore jurisdictions such as Bermuda, British Virgin Islands and Cayman Islands.

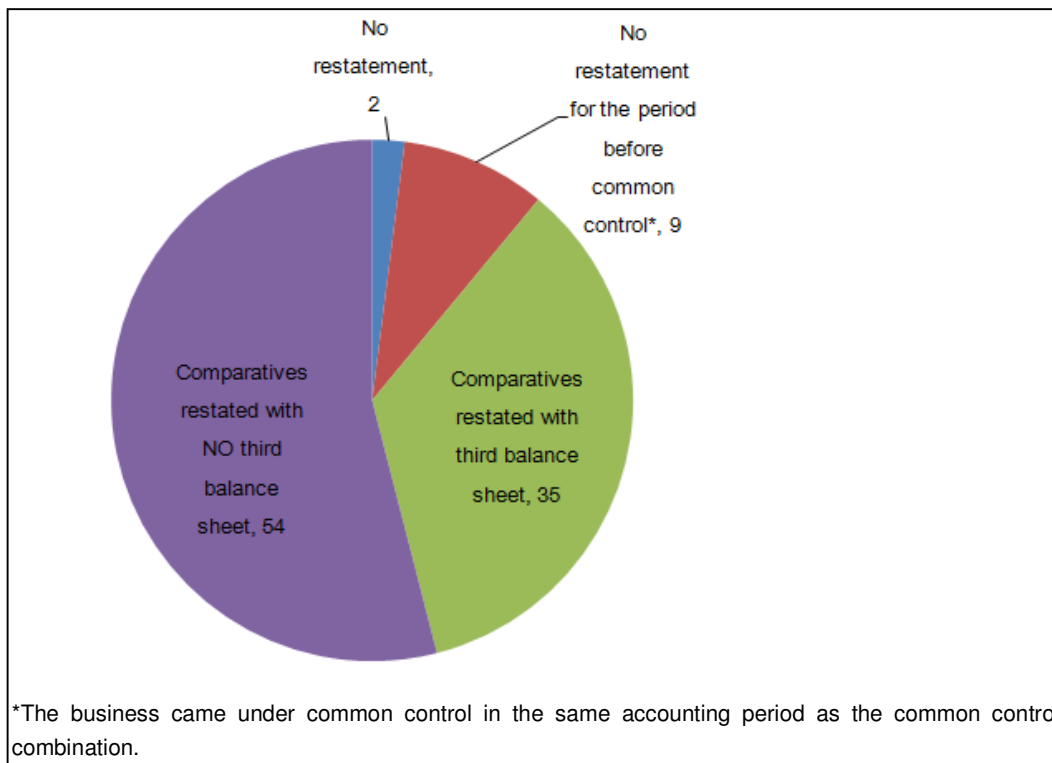
About half of the identified combinations regarded the ultimate parent as the controlling party. 38% of the identified combinations regarded an intermediate/immediate parent as the controlling party. The remaining 12% of combinations did not specify the controlling party. H-share companies identified SOEs as the controlling parties in most of their common control combinations.

Although most companies disclosed the identity of the controlling party, many companies did not specify whether the carrying values of the acquired business were taken from the controlling party's financial statements or the acquiree's own financial statements. The carrying values of the acquired business at the controlling party level could be different from the carrying value in the acquiree's own financial statements if the business was previously acquired from a third party by the controlling party before the common control combination.

### Whether comparatives information was restated

AG 5 and CASBE require an acquirer to report comparative financial information of the newly combined businesses as if the combined businesses had always existed – this represents the continuation of the risks and benefits from the controlling party's perspective.

Among the identified common control combinations in this study, there are variations in the presentation of comparative figures in the financial statements.



Most companies in this study restated their comparatives as if the businesses had been combined at the beginning of the previous accounting period (unless the combining businesses first came under common control at a later date). These companies also disclosed the impact of such restatement in the statement of changes in equity and/or in the notes to the financial statements.

Among those companies who restated comparatives, less than half of the companies chose to disclose a 'third balance sheet' as at the beginning of the comparative period under paragraph 40A of HKAS 1 *Presentation of Financial Statements*.<sup>13</sup> HKAS 1 requires a 'third balance sheet' is presented when an accounting policy is retrospectively applied.

Nine combinations did not restate their comparatives because the businesses came under common control in the same accounting period as the common control combinations. In these situations, the common control combination was accounted for as if it had been taken place at the beginning of the current accounting period.

The remaining two combinations, both of which adopted IFRS, did not restate comparatives. One of the companies explained in the financial statements that it did not restate comparatives because the financial impact of the transaction was insignificant to the group. The other company did not disclose reasons for not restating comparatives.

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13 There are different views as to whether an entity restating its comparatives under AG 5 is required to present a 'third balance sheet' under paragraph 40A of HKAS 1. Some consider that the predecessor method assumes that the newly combined entities have always existed, and when an entity applies the predecessor method retrospectively, this triggers the requirement to present a 'third balance sheet'. Others consider that entities restate their comparatives just because of the requirements under AG 5 and there is no change in accounting policy. Therefore, there is no need to apply the requirement in HKAS 1 to present a 'third balance sheet'.

## Appendix

### Differences between the acquisition method and the predecessor method

	Predecessor method	Acquisition method
<b>Principles</b>	<ul style="list-style-type: none"> <li>No acquisition has occurred from the controlling party's perspective</li> <li>Continuation of risks and benefits to the controlling party</li> </ul>	<ul style="list-style-type: none"> <li>Acquisition of business at arm's length from third party</li> <li>The acquirer obtains new synergies and control over new business</li> </ul>
<b>Accounting requirements</b>	All assets and liabilities of the transferred entity reported at their existing carrying amounts (i.e. no revaluation) at acquisition date	All assets and liabilities of the acquired business reported at their fair values at acquisition date
	No additional depreciation or amortization in subsequent years	Additional depreciation or amortization arising from revalued assets (if any) in subsequent years
	No goodwill	Goodwill or gain from a bargain purchase
	Prior periods financial information presented as if the combining entities had always been combined	No restatement of prior periods financial information



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