30 March 2005

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

Exposure Draft – Accounting Guideline on Merger Accounting

Comments to be received by 31 May 2005

Issued by the Council,
Hong Kong Institute of Certified Public Accountants

The Hong Kong Institute of Certified Public Accountants' Council (Council) has issued for consultation an *Exposure Draft of Proposed Accounting Guideline on Merger Accounting.*

The Exposure Draft sets out the proposed basic principles and procedures of merger accounting and will result in the withdrawal of SSAP 27 *Accounting for Group Reconstructions* upon its finalisation.

The Council invites comments on the Exposure Draft from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the Exposure Draft. Comments should be supported by specific reasoning and should preferably be submitted in written form.

Comments are requested to be received by **31 May 2005** and may be sent by mail, fax or e-mail to:

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

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Specific matters for commentators

The Council wishes to seek comments specifically on the following matters in relation to the Exposure Draft:

(1) Business combinations that take place after the balance sheet date but before the approval of the consolidated financial statements by the directors

The Exposure Draft proposes to allow, in applying merger accounting, the financial statement items of the combining entities or businesses, that are under common control but a legal group has not been formed during the reporting periods where there is common control, to be included in the consolidated financial statements of the combined entity, provided that the business combination under which the legal group is formed is completed before the date of approval of the consolidated financial statements by the directors.

(2) Presentation of comparative balance sheet

The Exposure Draft includes an appendix that contains an example illustrating the comparative consolidated balance sheet of Entity A as at 31 December 20X0 based on the background information set out therein. The Council is aware of the fact that an alternative presentation of the comparative consolidated balance sheet as illustrated below is also used in practice.

Alternative presentation of the comparative consolidated balance sheet of Entity A as at 31 December 20X0:

	Entity A	Entity X	Entity Y	Consolidated
	HK$	HK$	HK$	HK$
Net assets	9,000	80,000	100,000	189,000
Share capital	10,000	10,000	20,000	40,000
Accumulated profits (losses)	(1,000)	70,000	80,000	149,000
	9,000	80,000	100,000	189,000

Note: The comparative figures are restated as if the entities had been combined at the previous balance sheet date. The consolidated share capital represents the aggregate amount of the share capital of each of the entity.

Commentators are encouraged to state their views on the proposal set out in (1) above and whether the alternative presentation of comparative balance sheet as set out in (2) above should be allowed and, if possible, specify their reasons.

30 March 2005
Exposure Draft

Response Due Date
31 May 2005

Draft Accounting Guideline

Merger Accounting

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

ACCOUNTING GUIDELINE ON MERGER ACCOUNTING

(Response Due Date 31 May 2005)

CONTENTS

Accounting Guideline on Merger Accounting is set out in paragraphs 1-21. The scope and authority of Accounting Guidelines are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Introduction

1. Starting from 1 January 2005, HKFRS 3 *Business Combinations* applies to all business combinations except where a combination is specifically excluded from its scope. For those business combinations outside the scope of HKFRS 3, for example, business combinations involving entities or businesses under common control, there is no accounting standard addressing the appropriate accounting treatment.

2. HKFRS 3 defines a business combination involving entities or businesses under common control as "a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory".

3. According to HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, in the absence of a Standard or an Interpretation, management should select an appropriate accounting policy that results in the most useful information to the users of the financial statements and apply it consistently for the transaction.

4. For business combinations that fall outside the scope of HKFRS 3, an entity is allowed to select the purchase method or another appropriate accounting method to account for the transaction. In practice, merger accounting is often used for business combinations involving entities or businesses under common control.

5. This accounting guideline sets out the basic principles and procedures of merger accounting.

Merger Accounting

The principles

6. The concept underlying the use of merger accounting to account for a business 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 business 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.

7. In applying merger accounting, the financial statement items of the combining entities or businesses:

   (a) for the reporting period:

      (i) in which the business combination occurs; or

      (ii) after which the business combination is completed before the date of approval of the consolidated financial statements of the combined entity by the directors; and

   (b) 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 were under common control, regardless of the date of combination.

8. Where the combining entities or businesses included 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. Where the combining entities or businesses have been under common control but have not formed a legal group throughout the reporting periods, the financial statement items of the entities or businesses are presented on a combined basis in the consolidated financial statements of the combined entity provided that the business combination under which the legal group is formed is completed before the date of approval of the consolidated financial statements by the directors.

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 their book values as previously stated in the financial statements of the controlling party or parties prior to the business combination or existing book values if no such financial statements had previously been prepared by the controlling party or parties, adjusted only as a result of conforming with the combined entity's accounting policies and applying those policies to all periods presented. There is no recognition of any new goodwill or excess of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities over cost. Similarly, 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

10. The practical effects of merger accounting are that:

    (a) the new shares issued as consideration for the business combinations are recorded at their nominal amount (their fair value being ignored) subject to any statutory requirement to record the shares issued in the books of the issuing entity, such as in the case of the Hong Kong Companies Ordinance, a share premium account may be required to be set up where the consideration of the shares issued is in excess of the amount credited as paid up;

    (b) the net assets of the combining entities or businesses are consolidated using existing book values from the controlling parties' perspective. 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 goodwill, intangibles, 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 minority interests recorded in the consolidated financial statements of the controlling party). When the controlling party does not prepare financial statements, the book values from the financial statements of the acquired entity are used; and

    (c) 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.

11. The consolidated income statement includes the results of each of the combining entities or businesses for the entire period or since the date when the combining entities or businesses were under common control, where this is a shorter period, regardless of the date of the business combination, and the corresponding amounts in the consolidated financial statements are restated to the aggregate of the amounts recorded by the combining entities or businesses.

12. Expenditure incurred in relation to a business 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 business combination. It also includes any costs or losses incurred in combining operations of the previously separate businesses.

13. The principal consolidation entries are as follows:

    (a) any difference between the amount recorded as share capital issued plus the fair value of any additional consideration in the form of cash or other assets and the amount recorded for the share capital acquired is included in equity as a separate reserve and the reserves of the combining entities are aggregated;

    (b) the effects of all transactions between the combining entities or businesses, whether occurring before or after the combination, are eliminated; and

    (c) 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.

Accounting period covered by a newly formed parent

14. When a business combination is 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, it frequently happens that the first accounting reference period of the new parent will be a period of less than a year, ending on the accounting year end date chosen for the group. This will normally be the existing accounting year end date of one or more of the combining entities or businesses.

15. Frequently, the date of formation will be arbitrary and will not coincide with 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. This may imply that there could be no comparative figures at all. In substance, however, where the combining entities or businesses are continuing to trade as before, but with a new legal parent, it will be appropriate to prepare consolidated financial statements as if the parent had been in existence throughout the reported periods, but with a prominent footnote explaining the basis on which consolidated financial statements are presented.

Presentation of comparative figures

16. The comparative amounts in the consolidated financial statements are restated as if the entities or businesses had been combined throughout the previous period and at the previous balance sheet date. This requires a restatement of the comparative figures to include the results for all the combining entities or businesses for the previous period and their balance sheets for the previous balance sheet date, or since the date when the combining entities or businesses were under common control, where this is a shorter period. Adjustments are made as necessary to achieve uniformity of accounting policies.

Disclosure

17. Entities applying this Accounting Guideline in accounting for a business combination using the principles of merger accounting shall disclose in their consolidated financial statements the fact that it has been used.

18. Entities shall disclose the accounting policy that it applies in accounting for a business combination by using the principles of merger accounting. The accounting policy shall include, but not be limited to, a discussion of the specific principles and bases applied under merger accounting.

19. Bearing in mind the necessity of showing a true and fair view, entities applying this Accounting Guideline shall disclose in their consolidated financial statements significant details of the business combinations.

20. For each business combination accounted for by using merger accounting, the following information shall be disclosed:

    (a) the names of the combining entities (other than the reporting entity);

    (b) the date of the business combination;

    (c) any operations resulting from the business combination which the entity has decided to dispose of;

    (d) an analysis of the principal components of the current year's income statement and statement of changes in equity into:

        (i) amounts relating to the combined entity for the period after the date of the business combination, and

(ii) for each combining entity or business, amounts relating to that entity or business for the period up to the date of the business combination;

(e) the composition of the consideration and fair value of the consideration other than shares issued;

(f) the nature and amount of significant accounting adjustments made to the net assets of any entities or businesses to achieve consistency of accounting policies, and an explanation of any other significant adjustments made to the net assets of any entity or business as a consequence of the business combination; and

(g) a statement of the adjustments to consolidated reserves.

Earnings per share

21. Ordinary shares issued as part of a business 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 business combination which is accounted for using merger accounting is the aggregate of the weighted average number of shares of combining entities, adjusted to equivalent shares of the entity whose shares are outstanding after the combination.

APPENDIX

Example

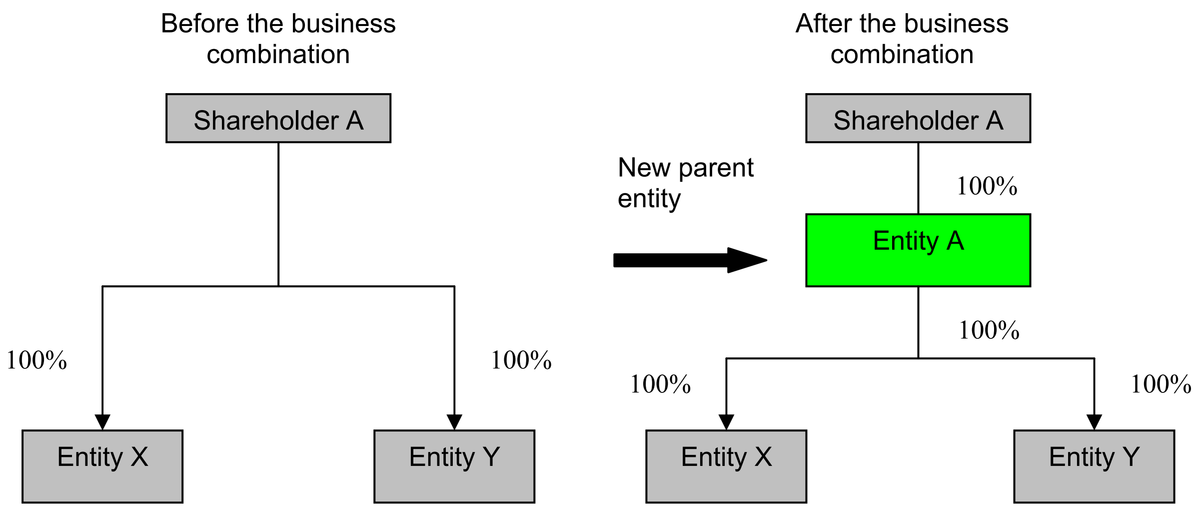
This Appendix does not form part of the Accounting Guideline and is included for illustrative purposes only.

Background information

On 1 January 20X0, Shareholder A 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 Shareholder A. In return, Entity A issued 10,000 ordinary shares with par value of HK$1 each to Shareholder A. Entity A, Entity X and Entity Y have financial year end of 31 December.

Ignore the tax effect arising from the business combination.



The balance sheets of Entity A, Entity X and Entity Y as at 31 December 20X1 are:

	Entity A (before issue of shares)	Entity A (after issue of shares#)	Entity X	Entity Y
	HK$	HK$	HK$	HK$
Investment in subsidiaries	-	10,000	-	-
Other assets	5,000	5,000	100,000	120,000
Net assets	5,000	15,000	100,000	120,000
Share capital	10,000	20,000	10,000	20,000
Accumulated profits (losses)	(5,000)	(5,000)	90,000	100,000
	5,000	15,000	100,000	120,000

The new shares issued by Entity A as consideration are recorded at their nominal value, i.e. HK$10,000 (assuming that there is no statutory requirement to record any share premium).

The balance sheets of Entity A, Entity X and Entity Y as at 31 December 20X0 are:

	Entity A	Entity X	Entity Y
	HK$	HK$	HK$
Net assets	9,000	80,000	100,000
Share capital	10,000	10,000	20,000
Accumulated profits (losses)	(1,000)	70,000	80,000
	9,000	80,000	100,000

Analysis

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

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

Under merger accounting, the net assets of Entity X and Entity Y are not restated to their fair values and goodwill will not arise from the business combination.

The consolidated balance sheet of Entity A as at 31 December 20X1 is:

	Entity A	Entity X	Entity Y	Adjustments		Consolidated
	HK$	HK$	HK$	HK$	Adj	HK$
Investments in Entity X and Entity Y	10,000	-	-	(10,000)	(1)	-
Other assets	5,000	100,000	120,000			225,000
Net assets	15,000	100,000	120,000			225,000
Share capital	20,000	10,000	20,000	(30,000)	(1)	20,000
Other reserve	-	-	-	20,000	(1)	20,000
Accumulated profits (losses)	(5,000)	90,000	100,000			185,000
	15,000	100,000	120,000			225,000

Adjustment

(1) Adjustment to eliminate the share capital of Entity X and Entity Y against the investment cost of Entity A. The difference between the nominal amount of share capital issued by Entity A for the purpose of the business combination and the nominal amount of share capital of Entity X and Entity Y acquired is included in a separate reserve.

The comparative consolidated balance sheet of Entity A as at 31 December 20X0 is:

	Entity A	Entity X	Entity Y	Adjustments				Consolidated
	HK$	HK$	HK$	HK$	Adj	HK$	Adj	HK$
Net assets	9,000	80,000	100,000					189,000
Share capital	10,000	10,000	20,000	10,000	(1)	(30,000)	(2)	20,000
Other reserve				(10,000)	(3)	30,000	(3)	20,000
Accumulated profits (losses)	(1,000)	70,000	80,000					149,000
	9,000	80,000	100,000					189,000

Note: The comparative figures are restated as if the entities had been combined at the previous balance sheet date. The consolidated share capital represents the share capital of Entity A adjusted for the share capital issued for the purposes of the business combination.

Adjustments

(1) Adjustment to push back the share capital issued for the purposes of the business combination. The aim of the consolidated financial statements in merger accounting is to show the combining entities' results and financial positions as if they had always been combined. Consequently, the share capital issued for the purposes of the business combination has to be shown as if it had always been issued.

(2) Adjustment to eliminate the share capital of Entity X and Entity Y against the investment cost of Entity A.

(3) The difference between the nominal amount of share capital issued by Entity A for the purpose of the business combination and the nominal amount of share capital of Entity X and Entity Y acquired is included in a separate reserve.