

Meeting Summary

Discussion on HKICPA Request for Information: PIR of AG 5

Date: 13 September 2016

Venue: Offices of HKICPA

Participant: Not disclosed, RSM Nelson Wheeler

1. This practitioner considers the main challenges relating to AG 5 are:
 - (a) assessing whether a common control combination is within the scope of AG 5;
 - (b) determining the controlling party; and
 - (c) the conceptual reasoning for recognizing minority interest from the former controlling party's perspective.

Scope and authority of AG 5

2. This practitioner observed that common control transactions occur frequently in Hong Kong in family businesses under the control of one or several individual(s). There are two major reasons for these common control combinations—for IPO and possible tax savings. He also observes that in these cases the consideration paid is usually nominal.

Common control combinations for the purpose of IPO

3. In some cases in preparation for IPO, a holding company is created to operate between the ultimate controlling individual and the subsidiaries before the new holding company goes IPO. This scenario is explicitly scoped out from AG 5.
4. In other cases, several legal subsidiary entities held by the ultimate/intermediate parent company, together form a business (as defined in HKFRS 3 *Business Combinations*), but are not otherwise businesses on their own. However, the group restructuring performed does not meet the definition of a 'business'. It is therefore questionable whether this scenario is under the scope of AG 5.
5. In general, this practitioner considers many financial reports prepared for IPO do not explicitly state whether AG 5 is applied because there is room for interpreting or there is some ambiguity in the scope of AG 5. Therefore, he strongly suggests that the scope of common control combination be more specifically defined. For example, it would be useful if AG 5 includes an example of a structure that fails to meet the scope of AG 5 (or fails the definition of a BCUCC).
6. In practice, the "principles of merger accounting" would be applied in both situations to meet the listing requirements (i.e. 3-year track record period). He notes that some companies with more transparent disclosures would explain why the "principles of merger accounting" were applied to account for the restructuring—in most cases, the reasons are because the restructure does not represent a distinct business or because the restructure is a recapitalisation.

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7. He notes that some practitioners think that AG 5 should be applied for listed entities performing common control combinations to maintain consistency in accounting policy both pre- and post-IPO. However, he thinks that some clarity on whether financial reports prepared for IPO are special purpose reports or general purpose reports. If the former, the company should have a choice to apply AG5 or the acquisition method to future common control combinations when preparing general purpose financial reports.
8. He observes that many listed entities he dealt with do not voluntarily apply the acquisition method for common control combinations. This is because even if the consideration paid is determined at fair value, the exercise of valuing and allocating the fair value to individual assets is time consuming and costly. Furthermore, he observes that many companies prefer to avoid dealing with goodwill.

Common control combinations for the purpose of tax schemes

9. This practitioner observes that a form of predecessor method will be applied to group restructures for the purpose of tax schemes as the acquisition method (fair values) is typically more costly and is not useful to entities/individuals that have no plans to sell.

Applying principles of AG5: Controlling party and carrying values

10. He commented that it is unclear who is the controlling party as required by AG 5 paragraph 9 and suggests further rationale in AG 5 paragraph 6 for taking the carrying values from the controlling party's perspective. He also notes that in practice it is rare for companies to specify/disclose which party is the controlling party.
11. This is particularly problematic for private family businesses as individuals considered the ultimate controlling party do not normally prepare financial statements. The most readily available carrying values are usually from the intermediate holding company. In addition, he commented that identifying the controlling party may be very judgmental particularly when the controlling party may be represented by several individuals. Oftentimes, these individuals may not have contractual agreements between them to specify how strategic financial and operating decisions are made.

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12. He recommends that AG 5 should include guidance or principles to assist in determining who is the controlling party and the objectives/rationales for requiring the carrying values from the controlling party's perspective. In his experience, determining who are the shareholders and directors, and how the businesses are financed and managed, could be useful factors for identifying who is the controlling party

Applying principles of AG5: Minority interests

13. This practitioner noted that there is diversity in accounting for minority interests in common control combinations. Minority interests can be accounted for from the controlling party's perspective prior to the common control combination in accordance with paragraphs 9 and 10(a) of AG 5. Alternatively, minority interest can be accounted for from the combining entity's perspective as if the current group structure has always existed in accordance with paragraph 7 of AG 5. In practice, minority interest calculated from the above two alternatives can result in different outcomes and is often confusing to investors.

14. He therefore recommends that the principle in AG 5 is reconsidered and that AG 5 explains the rationale for the principle.

Applying principles of AG5: Comparatives

15. This practitioner also notes that in general, preparing the comparative amounts in financial statements on an 'as if' basis is quite theoretical, and not based on commercial reality. Having said that, he is aware that potential investors may find the restatement of comparatives in pre-IPO situations on an 'as if' basis useful for their trend analysis. He reiterates the importance in clarifying whether IPO reports are special purpose and therefore warrants the hypothetical or pro-forma comparative restatements.

16. It is typically challenging and time-consuming to restate comparatives. Refer to paragraphs 13-14 (regarding minority interest) and paragraphs 17-19 (regarding consideration paid).

Accounting for the consideration paid

17. He commented that if shares are paid as consideration, there is diversity in practice with respect to restating comparatives and measuring its cost. It is unclear whether to record the share at net asset value of the acquired business, fair value of the shares transferred, or at cost. It would be useful if AG 5 provides more guidance in this area.

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18. If cash is paid as consideration, it is recorded in the period in which the payment is made, hence not recorded in prior periods 'as if' the combination took place then.
19. AG 5 could provide some principles or explain the rationale for how to deal with the different forms of consideration.

Applying principles of AG5: Disclosures

20. This practitioner considers that recognizing the acquired business at book values per AG 5's principles is useful only if investors know where the book values come from. The controlling party and the carrying value basis should therefore be disclosed.