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Exposure Draft

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Exposure Draft

Proposed Amendments to Accounting Guideline 5 *Merger Accounting for Common Control Combinations* (AG 5)

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

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The Exposure Draft can also be found on the Institute's website at:
www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/

Introduction

In August 2016, the Financial Reporting Standards Committee (FRSC) of the Hong Kong Institute of Certified Public Accountants (Institute) issued a Request for Information to conduct a post-implementation review (PIR) of AG 5. The comment period closed in 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 Advisory Panel, comprising preparers, technical experts from accounting firms and representatives of regulatory bodies in Hong Kong. The PIR also asked for feedback on and assessed the benefits, challenges and other effects of applying AG 5.

The PIR Feedback Statement, issued in August 2018, provides an overview of the Institute's PIR process and a summary of responses received from constituents and the key issues identified.

Based on the feedback received, the FRSC:

(a) noted that addressing certain constituents' comments and feedback would require amendments to the principles and accounting requirements in AG 5. However, the FRSC noted that the International Accounting Standards Board (IASB) is currently discussing the accounting approach for transactions within the scope of its Business Combination Under Common Control (BCUCC) project, and the project has not yet been finalised. The FRSC considered the importance of responding to the feedback versus the burden and confusion for preparers and users of financial statements in Hong Kong of making two significant sets of changes to the accounting for common control combinations within a short timeframe. On balance, the FRSC proposes not to amend the principles and accounting requirements in AG 5 now that could be affected by the outcome of the IASB BCUCC's project; and

(b) proposes the following limited amendments to AG 5 in order to assist the Institute's members in applying AG 5 during the interim period, before the IASB's project is finalised.

Proposed amendments	Rationale
Updating the terminologies and references in AG 5	The FRSC noted that some of the terminologies and references in AG 5 are outdated. In order to avoid confusion or misinterpretation, the FRSC proposes updating the terminologies and references in AG 5 to align with existing Hong Kong Financial Reporting Standards.

Proposed amendments	**Rationale**
Providing clearer rationale in paragraph 5 of AG 5	The FRSC noted that on the one hand paragraph 5 of AG 5 states that interspersing a shell entity between a parent entity and a single subsidiary is not a business combination, but on the other hand it refers to the accounting treatment for reverse acquisition under HKFRS 3, which applies to business combinations. Therefore, to avoid confusion, the FRSC proposes to clarify the rationale for why the transaction described in paragraph 5 of AG 5 is not a business combination and why, in practice, a principle similar to that for a reverse acquisition is applied to those transactions.
Adding new disclosure requirements to paragraph 19 of AG 5	To help financial statement users better understand the background of the common control combinations and hence the impact of the transactions on the financial position and performance of the reporting entity, the FRSC proposes the following new disclosure requirements: • the name and a brief description of the controlling party; • brief descriptions of the combining entities; and • the reasons for the common control combination and a description of how the reporting entity obtained control. The FRSC considers that entities would not need to incur significant costs and effort to provide this information in the financial statements because: • the proposed new disclosures mainly cover information about the background of the transactions and management should know all this information when entities undertake the transactions; and • entities are currently required to provide the same or similar disclosures for business combinations in the scope of HKFRS 3 *Business Combinations.*
Clarifying the accounting for change in non-controlling interests (NCI) in the existing example in AG 5	The comments reflected in the Feedback Statement indicate that AG 5 does not provide sufficient and clear guidance on accounting for changes in NCI as a result of common control combinations. To facilitate consistent application of AG 5, the

Proposed amendments	Rationale
	FRSC proposes clarifying the accounting for change in NCI in the existing example in AG 5.

Questions for respondents

1. Do you agree with the amendments proposed in this exposure draft? If not, please specify which parts of the proposals you disagree with, why, and what you propose instead.

2. Are there other amendments to AG 5 that the Institute should consider before the IASB finalises its BCUCC project? If so, please specify your proposed amendments and reasoning.

Amendments to Accounting Guideline 5 *Merger Accounting for Common Control Combinations* (AG 5)

[Draft] Amendments to AG 5

Paragraphs 4, 5, 9, 10(a), 11, 13 and 19 of AG 5 and Appendix of AG 5 are amended. New text is underlined and deleted text is struck through.

Introduction

…

4. This Accounting Guideline sets out the basic principles and procedures of merger accounting when recognising a common control combination. If there is any inconsistency between this Guideline and any Hong Kong Financial Reporting Standard or Interpretation (collectively referred to as "HKFRSs"), that Standard or Interpretation is to be followed. Certain HKFRSs may contain guidance or requirements that are relevant for the accounting for a common control combination using merger accounting. For example, HKAS 8 requires accounting policies to be applied consistently for similar transactions, ~~HKAS 27~~HKFRS 10 *Consolidated* ~~*and Separate*~~ *Financial Statements* addresses consolidation principles and the treatment of a disposal of a subsidiary and HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* addresses provisions for restructuring. Accordingly, an entity should apply that guidance or those requirements, instead of, or in addition to, the guidance set out in this Accounting Guideline when applying merger accounting.

5. ~~It should be noted that interspersing a shell entity between a parent entity and a single subsidiary does not represent the combination of two businesses and accordingly is not addressed in this Accounting Guideline.~~ A common control transaction involving inserting a shell entity between a parent entity and a single subsidiary or between a parent entity and a group of subsidiaries is not a business combination, and accordingly is not a 'common control combination' in this Accounting Guideline. This is because the shell entity is not a business as defined in HKFRS 3 and therefore the transaction does not represent the combination of two or more businesses. Because no substantive economic change has occurred to the composition or ownership of the group, ~~In~~ in practice, these transactions may be accounted for by applying a principle similar to that for a reverse acquisition. The consolidated financial statements of the shell entity represent the continuation of the financial statements of the single subsidiary or the group of subsidiaries. However, the equity structure in the consolidated balance sheet of the shell entity reflects the equity structure of the shell entity.

The principles

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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 the carrying amounts in the consolidated financial statements of the controlling party or parties prior to the common control combination. If consolidated financial statements were not previously prepared by the controlling party or parties, the carrying amounts are included as if such consolidated financial statements had been prepared, including adjustments required for conforming the combined entity's accounting policies and applying those policies to all periods presented. These carrying amounts are referred to below as ***existing book values from the controlling parties' perspective***. There is no recognition of any additional goodwill or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of the common control combination to the extent of the continuation of the controlling party or parties' interests. Similarly, in accordance with ~~HKAS 27~~HKFRS 10, 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 net assets of the combining entities or businesses are consolidated using the existing book values from the controlling parties' perspective (see paragraph 9). 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 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, any remaining goodwill arising on the previous acquisition and ~~minority interests~~ any non-controlling interests in the acquired entity recorded in the consolidated financial statements of the controlling party). When the controlling party does not prepare financial statements, the carrying amounts of the acquired entity are included as if such consolidated financial statements had been prepared;

…

11. The consolidated income statement includes the results of each of the combining entities or businesses from the earliest date presented (ie. including the comparative period) or since the date when the combining entities or businesses first came under the control of the controlling party or parties, where this is a shorter period, regardless of the date of the common control combination. The consolidated income statement also takes into account the profit or loss attributable to ~~the minority interest~~ non-controlling interests recorded in the consolidated financial statements of the controlling party.

…

13. Consolidation is performed in accordance with ~~HKAS 27~~HKFRS 10. The principal consolidation entries are as follows:

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

…

Disclosures in addition to those required by applicable HKFRSs

…

19. For each common control combination accounted for by using merger accounting, the following information shall be disclosed:

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

(b) the name and a brief description of the controlling party;

~~(b)~~(c) the date of the common control combination;

(d) the reasons for the common control combination and a description of how the reporting entity obtained control;

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

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

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

Appendix

Example

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Analysis

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

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

Under the principles of merger accounting, the assets and liabilities of Entity X and Entity Y are consolidated in the financial statements of Entity A using the existing book values as stated in the consolidated financial statements of Entity P immediately prior to the combination. This procedure requires recording of goodwill arising on the original acquisition of Entity X by Entity P and ~~minority interests~~ non-controlling interest in Entity Y as stated in the consolidated financial statements of Entity P immediately prior to the combination. There is no recognition of any additional goodwill or excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost at the time of this combination.

The consolidated income statement of Entity A for the year ended 31 December 20X1 is:

	Entity A	Entity X	Entity Y	Adjustment		Consolidated
	HK$	HK$	HK$	HK$	Adj	HK$
Revenue	2,000	40,000	50,000			92,000
Profit or loss	(4,000)	20,000	20,000			36,000
Attributable to the former ~~minority~~ non-controlling interest in Entity Y				5,000	(Y1)	(5,000)
Attributable to the equity holders of Entity A						31,000

Adjustment:

(Y1) Being an adjustment to reflect the profit attributable to the ~~minority interest~~ non-controlling interest in Entity Y prior to the 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$
Goodwill				3,000	(X1)	3,000
Investments in	223,000	-	-	(103,000)	(X3)	-
Entity X and Entity Y				(120,000)	(Y5)	
Other assets	5,000	100,000	120,000			225,000
Net assets	228,000	100,000	120,000			228,000
Capital (include						
share premium)	233,000	10,000	20,000	(10,000)	(X3)	233,000
				(20,000)	(Y5)	
Other reserve	-	-	-	(85,000)	(X3)	(160,000)
				(75,000)	(Y5)	
Accumulated profits	(5,000)	90,000	100,000	(5,000)	(X2)	155,000
/(losses)				(25,000)	(Y4)	
	228,000	100,000	120,000			228,000

Adjustments

Relating to Entity X:

(X1) Being an adjustment to record goodwill arising on the original acquisition of Entity X by Entity P as stated in the consolidated financial statements of Entity P immediately prior to the combination (HK$3,000).

(X2) Being an adjustment to eliminate the accumulated profits of Entity X generated prior to the original acquisition of Entity X by Entity P (HK$5,000).

(X3) Being an adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of HK$85,000 has been made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:

(Y4) Being an adjustment to reflect the profits attributable to the ~~minority interest~~ non-controlling interest in Entity Y prior to the combination.

(Y5) Being an adjustment to eliminate the share capital of Entity Y against the related investment cost of Entity A. An adjustment of HK$75,000 has been made to a separate reserve in the consolidated financial statements of Entity A.
Paragraph 10(a) of this Guideline indicates that any non-controlling interests in the combining businesses reflect the amounts recorded in the consolidated financial statements of the controlling party, in this case Entity P. Accordingly, the 25% shareholdings in Entity Y held by third parties before the combination have been presented as non-controlling interests. After the combination, Entity Y became a wholly-owned subsidiary of Entity A; as such, no non-controlling interests have been presented in the consolidated balance sheet of Entity A as at 31 December 20X1. Since the non-controlling interests in Entity Y were acquired at the same time as the common control combination, the change in the non-controlling interests is accounted for as an equity transaction at the date of the combination.

The consolidated income statement of Entity A for the year ended 31 December 20X0 is:

	Entity A	Entity X	Entity Y	Adjustment		Consolidated
	HK$	HK$	HK$	HK$	Adj	HK$
Revenue	1,000	38,000	45,000			84,000
Profit or loss	(2,000)	15,000	12,000			25,000
Attributable to the ~~minority interest~~ non-controlling interest				3,000	(Y1)	(3,000)
Attributable to the equity holders of Entity A						22,000

Adjustment:

(Y1) Being an adjustment to reflect the profit attributable to the ~~minority interest~~ non-controlling interest in Entity Y.

The 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$
Goodwill				3,000	(X2)	3,000
Investments in	-	-	-	193,000	(1)	-
Entity X and				(103,000)	(X4)	
Entity Y				(90,000)	(Y5)	
Other assets	9,000	80,000	100,000			189,000
Net assets	9,000	80,000	100,000			192,000
Capital (include						
share premium)	10,000	10,000	20,000	193,000	(1)	203,000
				(10,000)	(X4)	
				(20,000)	(Y5)	
Other reserve	-	-	-	(85,000)	(X4)	(160,000)
				(75,000)	(Y5)	
~~Minority interests~~						
Non-controlling						
interests	-	-	-	25,000	(Y5)	25,000
Accumulated profits	(1,000)	70,000	80,000	(5,000)	(X3)	124,000
/(losses)				(20,000)	(Y5)	
	9,000	80,000	100,000			192,000

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) Being an adjustment to push back the capital issued for the purposes of the business combination (HK$193,000, of which HK$103,000 relating to Entity X and HK$90,000 relating to Entity Y). 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 in respect of 7,000 shares

issued for the purposes of the business combination has to be shown as if it had always been issued.

Relating to Entity X:

(X2) Being an adjustment to record goodwill arising on the original acquisition of Entity X by Entity P as stated in the consolidated financial statements of Entity P immediately prior to the combination (HK$3,000).

(X3) Being an adjustment to eliminate the accumulated profits of Entity X generated prior to the original acquisition of Entity X by Entity P (HK$5,000).

(X4) Being an adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of HK$85,000 has been made to a separate reserve in the consolidated financial statements of Entity A.

Relating to Entity Y:

(Y5) Being an adjustment to eliminate the share capital of Entity Y against the related investment cost of Entity A. Prior to the business combination, Entity P only had 75% equity interest in Entity Y. ~~Minority interests~~ Non-controlling interests of HK$25,000 was recorded as at 31 December 20X0. An adjustment of HK$75,000 has been made to a separate reserve in the consolidated financial statements of Entity A.

Earnings per share

Based on the same facts as per the above example, the calculation of basic earnings per share for each period presented in the consolidated financial statements of Entity A is based on the consolidated profit (excluding the profit attributable to the ~~minority interests~~ non-controlling interests), and on the 17,000 shares (comprising 10,000 shares of Entity A in issue throughout the two years ended 31 December 20X1 and 7,000 shares of Entity A issued on 31 December 20X1 as consideration for the equity interests in Entity X and Entity Y acquired from Entity P).