

Accounting Guideline 5 (Revised)

Merger Accounting for Common Control Combinations

This Accounting Guideline is effective for common control combinations that occur on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.



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Hong Kong Accounting Guideline 5 (Revised)

Merger Accounting for Common Control Combinations

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 specific 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”. Such business combinations are referred to hereafter in this Accounting Guideline as “common control combinations” to distinguish them from other business combinations which fall within or outside the scope of HKFRS 3.
3. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 10-12, contain requirements for the selection of accounting policies in the absence of a Standard or an Interpretation that specifically applies to an issue. Common control combinations fall outside the scope of HKFRS 3. Accordingly, an entity selects an appropriate accounting policy in accordance with the requirements set out in HKAS 8 and many entities consider that merger accounting is an appropriate accounting policy for common control combinations.
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, HKFRS 10 *Consolidated 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. 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 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

6. The concept underlying the use of merger accounting to account for a common control 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 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, financial statement items of the combining entities or businesses for the reporting period in which the common control combination occurs, and 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 first came under the control of the controlling party or parties.
8. Where the combining entities or businesses include 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 using the acquisition values recognised at that date.
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 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 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;
 - (b) 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 at the time of common control combination, to the extent of the continuation of the controlling party or parties' interests; and

- (c) comparative amounts in the financial statements are presented using the principles as set out in paragraph 10(a) above as if the entities or businesses had been combined at the previous balance sheet date unless the combining entities or businesses first came under common control at a later date.
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 non-controlling interests recorded in the consolidated financial statements of the controlling party.
12. Expenditure incurred in relation to a common control 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 common control combination. It also includes any costs or losses incurred in combining operations of the previously separate businesses.
13. Consolidation is performed in accordance with 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
 - (b) 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. A common control combination may be 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. In such cases, the first accounting period of the new parent will frequently be a period of less than a year, ending on the balance sheet date chosen for the group. This will normally be the existing balance sheet date of one or more of the combining entities or businesses.
15. Frequently, the date of formation of the new parent will not coincide with the beginning or end of 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. It could be argued that this requirement prevents the disclosure of comparative information. In substance, however, where the combining entities or businesses are continuing to trade as before, but with a new legal parent, it is appropriate to prepare consolidated financial statements as if the parent had been in existence throughout the reported periods presented with a prominent footnote explaining the basis on which consolidated financial statements are prepared.

Disclosures in addition to those required by applicable HKFRSs

16. Entities applying this Accounting Guideline in accounting for a common control combination using the principles of merger accounting shall disclose in their consolidated financial statements the fact that this Guideline has been used.
17. Entities shall disclose the accounting policy applied in accounting for a common control combination by using the principles of merger accounting. Details of the accounting policy shall include, but not be limited to, a discussion of the specific principles and bases applied under merger accounting.

18. 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 common control combinations.
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;
 - (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;
 - (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 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
 - (g) a statement of the adjustments to consolidated reserves.

Earnings per share

20. Ordinary shares issued as part of a common control 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 common control combination which is accounted for using merger accounting is the aggregate of the weighted average number of shares of the entity whose shares are outstanding after the combination.

Effective date

21. This Accounting Guideline is effective for common control combinations that occur on or after the beginning of the first annual reporting period beginning on or after 1 January 2022. Earlier application of this Accounting Guideline is permitted. If an entity applies this Accounting Guideline for an earlier period, it shall disclose that fact.

APPENDIX

Example

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

Background information

Entity P has a number of subsidiaries. This example looks at three subsidiaries – Entity X, Entity Y and Entity A.

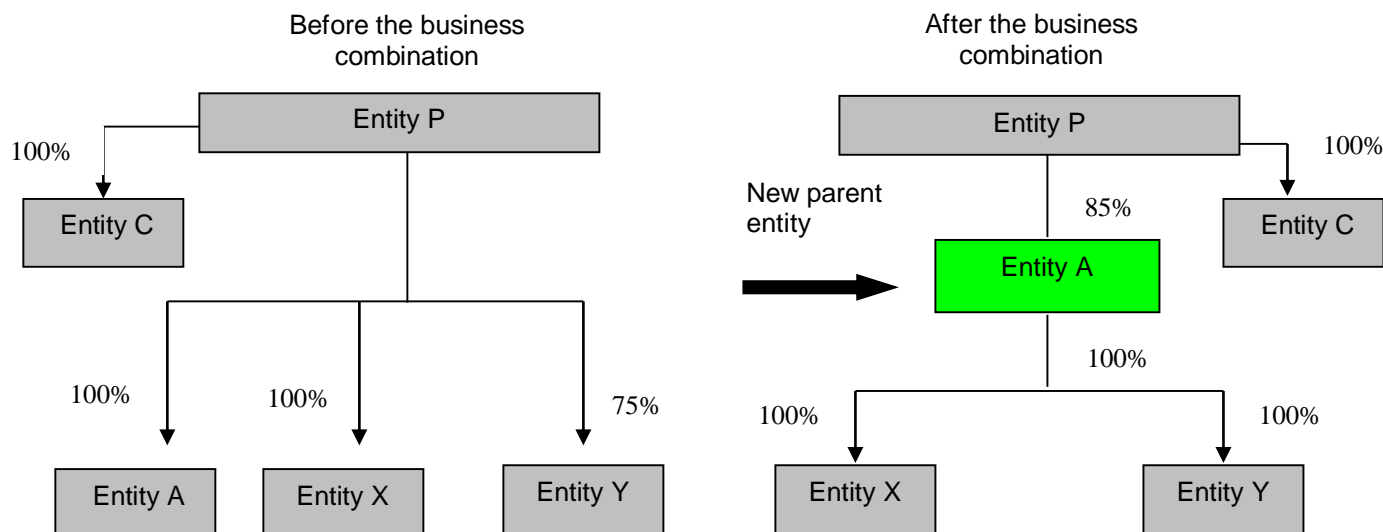
Entity P acquired 100% of Entity X for HK\$18,000 many years ago. At that time, Entity P recorded goodwill of HK\$3,000 and fair value of identifiable assets acquired of HK\$15,000 (which is equal to the then carrying amounts of the assets acquired).

Entity P set up Entity Y with a party outside the group, Shareholder S, many years ago. Entity P's cost of investment in Entity Y was HK\$15,000, being 75% of the share capital of Entity Y.

On 1 January 20X0, Entity P 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 Entity P and Shareholder S. In return, Entity A issued 7,000 and 3,000 ordinary shares with par value of HK\$1 each to Entity P and Shareholder S, respectively. Entity A, Entity X and Entity Y have financial year ends of 31 December. The fair values of assets and liabilities of Entity Y as at 31 December 20X1 are equal to their carrying values.

Ignore any tax effect arising from the business combination.



The income statements of Entity A, Entity X and Entity Y for the year ended 31 December 20X1 are:

	<u>Entity A</u> HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$
Revenue	<u>2,000</u>	<u>40,000</u>	<u>50,000</u>
Profit or loss	<u>(4,000)</u>	<u>20,000</u>	<u>20,000</u>

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

	<u>Entity A</u> (before issue of shares) HK\$	<u>Entity A</u> (after issue of shares#) HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$
Investment in subsidiaries	-	223,000	-	-
Other assets	5,000	5,000	100,000	120,000
Net assets	<u>5,000</u>	<u>228,000</u>	<u>100,000</u>	<u>120,000</u>
Capital (including share premium)	10,000	233,000	10,000	20,000
Accumulated profits (losses)	(5,000)	(5,000)	90,000	100,000
	<u>5,000</u>	<u>228,000</u>	<u>100,000</u>	<u>120,000</u>

The 10,000 new shares issued by Entity A as consideration are recorded at a value equal to the deemed cost of acquiring Entity X and Entity Y (HK\$223,000). The deemed cost of acquiring Entity X is HK\$103,000, being the existing book values of net assets of Entity X as at 31 December 20X1 (HK\$100,000) plus remaining goodwill arising on the acquisition of Entity X by Entity P (HK\$3,000). The deemed cost of acquiring Entity Y is HK\$120,000, being the existing book values of net assets of Entity Y as at 31 December 20X1. The deemed cost used in this example is for illustrative purposes only and does not necessarily represent the value to be reported in the individual financial statements of Entity A as the cost of acquiring the subsidiaries.

The income statements of Entity A, Entity X and Entity Y for the year ended 31 December 20X0 are:

	<u>Entity A</u> HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$
Revenue	<u>1,000</u>	<u>38,000</u>	<u>45,000</u>
Profit or loss	<u>(2,000)</u>	<u>15,000</u>	<u>12,000</u>

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

	<u>Entity A</u> HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$
Net assets	<u>9,000</u>	<u>80,000</u>	<u>100,000</u>
Capital (include share premium)	10,000	10,000	20,000
Accumulated profits/(losses)	<u>(1,000)</u>	<u>70,000</u>	<u>80,000</u>
	<u>9,000</u>	<u>80,000</u>	<u>100,000</u>

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 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:

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

Adjustment:

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

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

	<u>Entity A</u> HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$	<u>Adjustments</u> HK\$	Adj	<u>Consolidated</u> HK\$
Goodwill				3,000	(X1)	3,000
Investments in Entity X and Entity Y	223,000	-	-	(103,000)	(X3)	-
Other assets	5,000	100,000	120,000	(120,000)	(Y5)	225,000
Net assets	<u>228,000</u>	<u>100,000</u>	<u>120,000</u>			<u>228,000</u>
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 /(losses)	(5,000)	90,000	100,000	(5,000)	(X2)	155,000
				(25,000)	(Y4)	
	<u>228,000</u>	<u>100,000</u>	<u>120,000</u>			<u>228,000</u>

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 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 Accounting 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

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

Adjustment:

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

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

	<u>Entity A</u> HK\$	<u>Entity X</u> HK\$	<u>Entity Y</u> HK\$	<u>Adjustments</u>		<u>Consolidated</u> HK\$
				HK\$	Adj	
Goodwill				3,000	(X2)	3,000
Investments in Entity X and Entity Y	-	-	-	193,000 (103,000) (90,000)	(1) (X4) (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 (10,000) (20,000)	(1) (X4) (Y5)	203,000
Other reserve	-	-	-	(85,000) (75,000)	(X4) (Y5)	(160,000)
Non-controlling interests	-	-	-	25,000	(Y5)	25,000
Accumulated profits /(losses)	(1,000)	70,000	80,000	(5,000) (20,000)	(X3) (Y5)	124,000
	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. 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 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).