Consolidated Financial Statements

(Part 2)

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Consolidated Financial Statements

- The Companies Ordinance (Chapter 32)
- HKFRS 3 Business Combinations
- HKAS 27 Consolidated and Separate Financial Statements
- AG 5 Merger Accounting for Common Control Combinations

- HKAS 28 Investments in Associates
- HKAS 31 Interests in Joint Ventures

Workshop 1

- Business Combinations and Consolidation in Hong Kong

Workshop 2

- Changes in a group

> - More calculations in **Workshop 2** and **3**
> - You are welcome to bring your own calculator to practise

Workshop 3

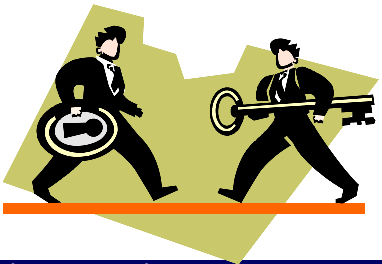
- Other consolidation issues

Agenda of Workshop 2

- The Companies Ordinance (Chapter 32)
- HKFRS 3 Business Combinations
- HKAS 27 Consolidated and Separate Financial Statements

Changes in a group

1. Reverse acquisition
2. Business combination achieved in stages (Step acquisition)
3. Disposal
   a. Full disposal
   b. Partial disposal
   c. Deemed disposal
   d. Business disposal



Requirements (from buy to sell)

Practical Examples

Real Cases

1. Reverse Acquisition

Changes in a group

1. Reverse acquisition

1. Reverse Acquisition

Scope

⇩

Method of accounting

⇩

Application of the method

- An entity shall account for each business combination by applying the acquisition method. (HKFRS 3.4)
- Applying the acquisition method requires:
  a) identifying the acquirer; Guidance in HKAS 27
  b) determining the acquisition date; Date of control obtained
  c) recognising and measuring
     - the identifiable assets acquired,
     - the liabilities assumed and
     - any non-controlling interest in the acquiree; and
  d) recognising and measuring
     - goodwill or
     - a gain from a bargain purchase. (HKFRS 3.5)

1. Reverse Acquisition

Scope

⇩

Method of accounting

⇩

Application of the method

- Applying the acquisition method requires:
  a) identifying the acquirer;

- The guidance in HKAS 27 *Consolidated and Separate Financial Statements* shall be used to identify the acquirer – the entity that obtains control of the acquiree.
- If a business combination has occurred but applying the guidance in HKAS 27 does not clearly indicate which of the combining entities is the acquirer, the factors in HKFRS 3.B14–B18 shall be considered in making that determination.

1. Reverse Acquisition

Indication of Control

- Control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.
- Presumed to have control when an entity acquires more than one-half of that other entity's voting rights, unless demonstrated contrary
- Even if no such voting rights, it might have control by obtaining:
  a) power over more than one-half of the voting rights of the other entity by virtue of an agreement with other investors; or
  b) power to govern the financial and operating policies of the other entity under a statute or an agreement; or
  c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body of the other entity; or
  d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body of the other entity.

1. Reverse Acquisition

Indication as an Acquirer

- In a business combination effected primarily by transferring cash or other assets or by incurring liabilities,
  - the acquirer is usually the entity that
    - transfers the cash or other assets or
    - incurs the liabilities.
- In a business combination effected primarily by exchanging equity interests,
  - the acquirer is usually the entity that issues its equity interests.

1. Reverse Acquisition

Indication as an Acquirer

- Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:
  a) the relative voting rights in the combined entity after the business combination
  b) the existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest
  c) the composition of the governing body of the combined entity
  d) the composition of the senior management of the combined entity
  e) the terms of the exchange of equity interests

1. Reverse Acquisition

Indication as an Acquirer

- The acquirer is usually the combining entity whose relative size (measured in, for example, assets, revenues or profit) is significantly greater than that of the other combining entity or entities.
- In a business combination involving more than two entities, determining the acquirer shall include a consideration of, among other things, which of the combining entities initiated the combination, as well as the relative size of the combining entities.
- A new entity formed to effect a business combination is not necessarily the acquirer.
  - If a new entity is formed to issue equity interests to effect a business combination, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in HKFRS 3.B13–B17 (as discussed now).
  - In contrast, a new entity that transfers cash or other assets or incurs liabilities as consideration may be the acquirer.

1. Reverse Acquisition

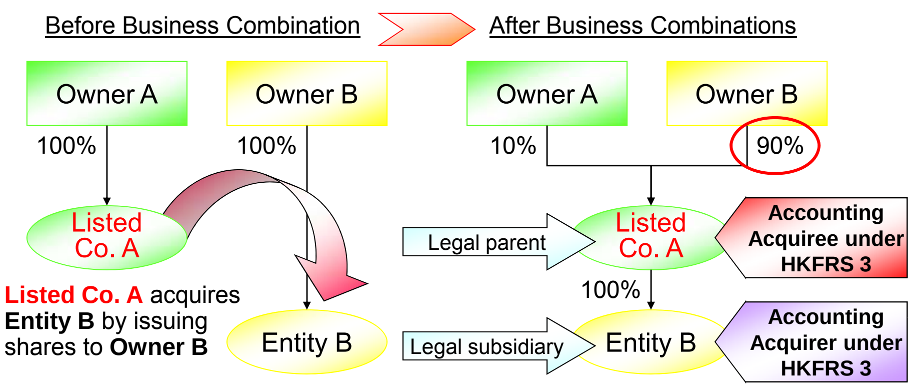
Indication as an Acquirer

- In some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree.
- A reverse acquisition occurs when:
  - the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in HKFRS 3.B13–B18 (as discussed in previous slides).
  - The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.

> e.g. reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares.
>
> a private entity arranges to have itself "acquired" by a smaller public entity as a means of obtaining a stock exchange listing
>
> also termed as "reverse takeover" or "back door listing"

1. Reverse Acquisition

Example



Which entity is the legal acquirer?
Which entity is the acquirer under HKFRS 3?

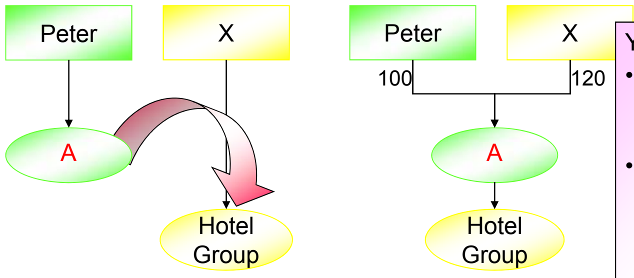
1. Reverse Acquisition

Example

Is the following case a Reverse Acquisition?

– Group A has 100 outstanding shares wholly owned by Peter
– It acquires Group X's interest in Hotel Group by issuing additional 120 outstanding to Group X

Before Business Combination → After Business Combinations



Yes, a reverse acquisition
- After the share issues, Group X will hold 54.5% of Group
- In substance, Hotel Group (or Group X, i.e. the owners of Hotel Group) has power to govern the financial and operating policies of Group A

1. Reverse Acquisition

Example

Is the following case a Reverse Acquisition?

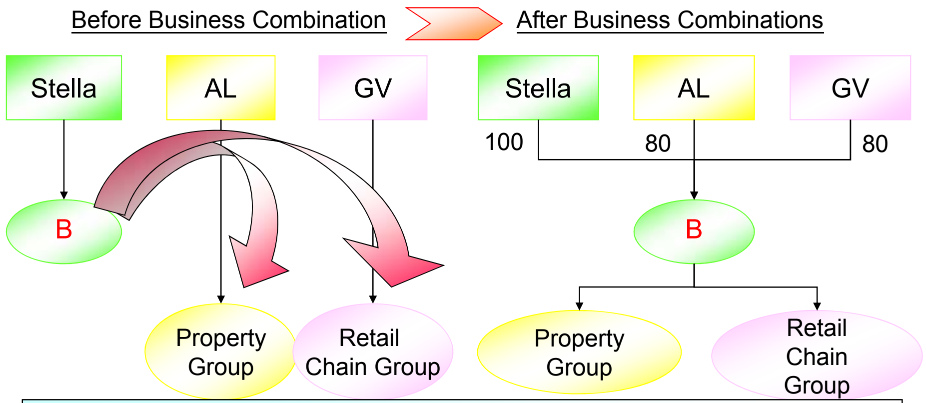
- Group B has 100 outstanding shares in issue wholly owned by Stella
- It acquires
  – Group AL's interest in Property Group by issuing 80 shares to Group AL
  – GV's interest in Retail Chain Group by issuing 80 shares to Group GV

Let's see the changes in group structure ……

1. Reverse Acquisition

Example

Is the following case a Reverse Acquisition?



Not a reverse acquisition

- Neither Property Group nor Retail Chain Group has the power to govern the financial and operating policies of Group B

1. Reverse Acquisition

Remember this Critical Amendment

- Recognising and measuring goodwill or a gain from a bargain purchase

Application of the method

- The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
  - a) the aggregate of:
    - i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
    - ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and
    - iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
  - b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with HKFRS 3. (HKFRS 3.32)

1. Reverse Acquisition

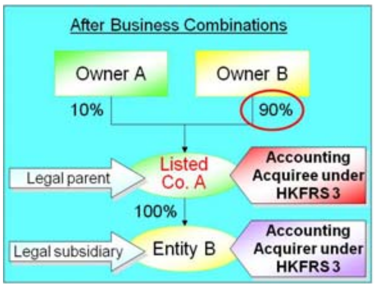
Example

Reverse Acquisition

A continuation of the financial statements of legal subsidiary

How does an entity account for a reverse acquisition?

- **Acquirer** – Legal subsidiary (Entity B in this case)
- **Consideration transferred**
  - Deemed to have been incurred by the legal subsidiary
  - Calculation shall be made to base on the no. of equity interests the legal subsidiary would have had to issue
    - to give the owners of the legal parent the same percentage equity interest in the combined entity (10% in this case)
- **Equity structure** – that of legal parent
- **Reserves at date of acquisition and Comparative** – that of the legal subsidiary
- **Consolidated** the fair value of net identifiable assets of the legal parent



1. Reverse Acquisition

How does an entity account for a reverse acquisition?

Reverse Acquisition

A continuation of the financial statements of legal subsidiary

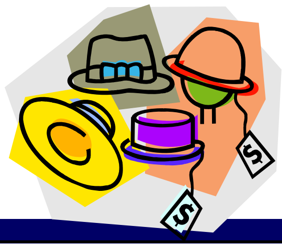
Let's analyse reverse acquisition in respect of

A. Consideration transferred (deemed cost)
B. Goodwill
C. Consolidate legal parent
D. Deemed issued equity and equity structure

1. Reverse Acquisition

A. Consideration Transferred

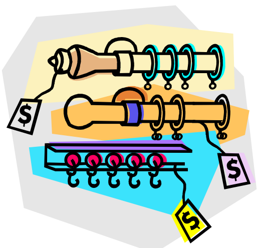
- HKFRS 3.B20 requires that, in a reverse acquisition, the acquisition-date fair value of the consideration transferred by the accounting acquirer for its interest in the accounting acquiree is based on
  - the number of equity interests the legal subsidiary would have had to issue
    - to give the owners of the legal parent the same percentage equity interest in the combined entity that results from the reverse acquisition.
- The fair value of the number of equity interests calculated in that way can be used as
  - the fair value of consideration transferred in exchange for the acquiree.



1. Reverse Acquisition

Example

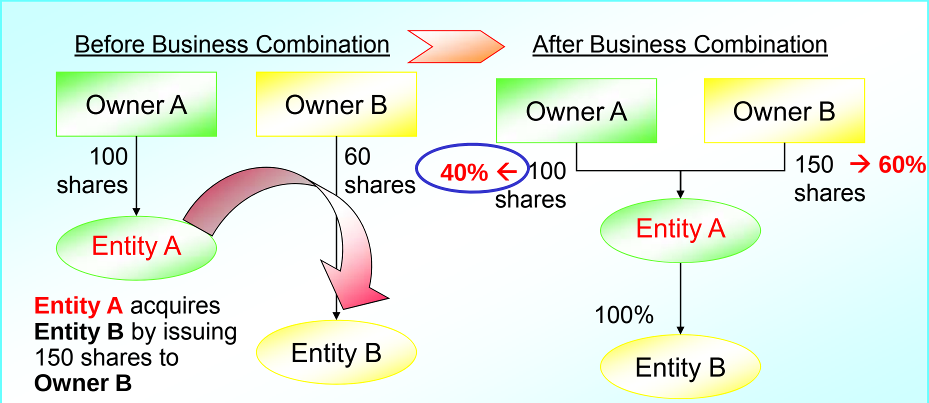
A. Consideration Transferred



- Immediately before the business combination,
  - A has 100 outstanding ordinary shares in issue and
  - B has 60 outstanding ordinary shares in issue.
- On 30 September 20X8,
  - A issues 2.5 shares in exchange for each ordinary share of B.
- All of B's shareholders exchange their shares in B.
- Therefore, A issues 150 ordinary shares in exchange for all 60 ordinary shares of B.
- The fair value of each ordinary share of B at 30 September 20X8 is $40.
- The quoted market price of A's ordinary shares at that date is $16.

1. Reverse Acquisition

Example



If the business combination had taken place in the form of B issuing additional ordinary shares to Owner A in exchange for their interest in A

- B would have had to issue 40 shares in order to give Owner A 40% interest in B
- 40 shares at a fair value of $40 each = $1,600 ← Consideration transferred

1. Reverse Acquisition

Example

	A	B
Current assets	500	700
Non-current assets	1,300	3,000
	1,800	3,700
Current liabilities	300	600
Non-current liabilities	400	1,100
	700	1,700
Net assets	*1,100*	*2,000*
Retained earnings	(800)	(1,400)
Issued equity		
100 ordinary shares	(300)	
60 ordinary shares	0	(600)
	(1,100)	*(2,000)*

- Following the previous example
  - A is "acquired" by B in a reverse acquisition.
- Except for non-current assets of A with a fair value of $1,500
  - The fair values of A's other assets are the same as their carrying amounts.

To be used for further discussion

1. Reverse Acquisition

B. Goodwill

- Goodwill is measured as the excess of
  - the fair value of the consideration effectively transferred over
  - the net amount of the legal parent's identifiable assets and liabilities.
- Goodwill and gain from bargain purchase should be accounted for in accordance with HKFRS 3.

1. Reverse Acquisition

Example

B. Goodwill

Following the previous example:

• Consideration effectively transferred		$ 1,600
• Net fair value of A's identifiable assets and liabilities:		
Current assets	500	
Non-current assets	1,500	
Current liabilities	(300)	
Non-current liabilities	(400)	
		1,300
• *Goodwill*		*$ 300*

1. Reverse Acquisition

C. Consolidate legal parent

- HKFRS 3.B21 requires that consolidated financial statements prepared following a reverse acquisition are
  - issued under the name of the legal parent (accounting acquiree)
  - but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer)
  - with one adjustment, which is to adjust retroactively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree.
    - That adjustment is required to reflect the capital of the legal parent (the accounting acquiree).
- Comparative information presented in those consolidated financial statements also is retroactively adjusted to reflect the legal capital of the legal parent (accounting acquiree).

1. Reverse Acquisition

C. Consolidate legal parent

- Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect:
  a) the assets and liabilities of the legal subsidiary (the accounting acquirer) recognised and measured at their pre-combination carrying amounts.
  b) the assets and liabilities of the legal parent (the accounting acquiree) recognised and measured in accordance with HKFRS 3.
  c) the retained earnings and other equity balances of the legal subsidiary (accounting acquirer) before the business combination.

1. Reverse Acquisition

C. Consolidate legal parent

- Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect:
  - d) the amount recognised as issued equity interests in the consolidated financial statements determined by adding
    - the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to
    - the fair value of the legal parent (accounting acquiree) determined in accordance with HKFRS 3.

    However, the equity structure (i.e. the number and type of equity interests issued) reflects the equity structure of the legal parent (the accounting acquiree), including the equity interests the legal parent issued to effect the combination.

    Accordingly, the equity structure of the legal subsidiary (the accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the accounting acquiree) issued in the reverse acquisition.

1. Reverse Acquisition

C. Consolidate legal parent

- Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure, the consolidated financial statements reflect:
  - e) the non-controlling interest's proportionate share of the legal subsidiary's (accounting acquirer's) pre-combination carrying amounts of retained earnings and other equity interests as discussed in HKFRS 3.B23 and B24.

1. Reverse Acquisition

Example

	A	B		Consolidated
Goodwill	0	0		300
Current assets	500	700		1,200
Non-current assets	1,300	3,000	(+$200 fair value)	4,500
	1,800	3,700		6,000
Current liabilities	300	600		900
Non-current liabilities	400	1,100		1,500
	700	1,700		2,400
Net assets	*1,100*	*2,000*		*3,600*
Retained earnings	(800)	(1,400)		(1,400)
Issued equity				
100 ordinary shares	(300)			
60 ordinary shares	0	(600)		
	(1,100)	*(2,000)*		

1. Reverse Acquisition

D. Deemed issued equity and equity structure

- HKFRS 3.B22(d) requires that, in reverse acquisition, the amount recognised as issued equity interests in the consol. fin. statements determined by adding
  - the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to
  - the fair value of the legal parent (accounting acquiree) determined in accordance with HKFRS 3.
- However, the equity structure (i.e. the number and type of equity interests issued) reflects
  - the equity structure of the legal parent (the accounting acquiree),
  - including the equity interests the legal parent issued to effect the combination.

In our example

B's $600

$1,600 (as calculated)

Total: $2,200

A's 100 shares

New 150 shares

Total: 250 shares

1. Reverse Acquisition

Example

	A	B		Consolidated
Goodwill				300
Current assets	500	700		1,200
Non-current assets	1,300	3,000		4,500
	1,800	3,700		6,000
Current liabilities	300	600		900
Non-current liabilities	400	1,100		1,500
	700	1,700		2,400
Net assets	*1,100*	*2,000*		*3,600*
Retained earnings	(800)	(1,400)		(1,400)
Issued equity				
100 ordinary shares	(300)		**250 ordinary shares**	**(2,200)**
60 ordinary shares	0	(600)		**0**
	(1,100)	*(2,000)*		***3,600***

1. Reverse Acquisition

- Reverse acquisition accounting applies only in the consolidated financial statements.
- Therefore, in the legal parent's separate financial statements, if any, the investment in the legal subsidiary
  - is accounted for in accordance with the requirements in HKAS 27 *Consolidated and Separate Financial Statements* on accounting for investments in an investor's separate financial statements.

1. Reverse Acquisition

Separate Financial Statements are defined in HKAS 27 as those presented by

- a parent, an investor in an associate, or a venturer in a jointly controlled entity,
- in which the investments are accounted for on the basis of the <u>direct equity interest</u> rather than on the basis of the reported results and net assets of the investees.

- They are those prepared and presented in addition to consolidated financial statements
- But they are not the financial statements of an entity that does not have a subsidiary, associate or venturer's interest in a jointly controlled entity

Same requirements apply to entities having associates or jointly controlled entities elect to present separate financial statements

1. Reverse Acquisition

- When separate financial statements are prepared
  - investments in subsidiaries, jointly controlled entities and associates (that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5) shall be accounted for either:

At cost or **In accordance with HKAS 39**

  - The same accounting shall be applied for <u>each category of investments</u>.
  - Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5
    - shall be accounted for in accordance with HKFRS 5

Same requirements apply to entities having associates or jointly controlled entities elect to present separate financial statements

1. Reverse Acquisition

- When separate financial statements are prepared
  - investments in subsidiaries, jointly controlled entities and associates (that are not classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5) shall be accounted for either:

At cost or **In accordance with HKAS 39**

At cost	In accordance with HKAS 39
• Investment is recognised at cost • Recognise income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition • Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment	• Investments in jointly controlled entities and associates that are accounted for in accordance with HKAS 39 in the consolidated financial statements – shall be accounted for in the same way in the investor's separate financial statements

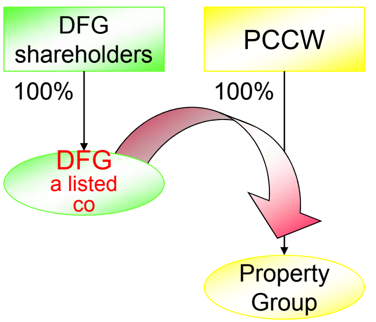
1. Reverse Acquisition

FA at FV through P/L	at Fair Value through profit or loss	
AFS financial assets	at Fair Value through equity at Cost	**In accordance with HKAS 39**
HTM investments	at Amortised Cost	
Loans and receivables	at Amortised Cost	

1. Reverse Acquisition

Case

PCCW



- In 2004, PCCW arranged
  - DFG, a HK listed co., to acquire one of its subsidiary which held interests in the Cyberport project and other properties interest.
- After the purchase
  - PCCW became the controlling shareholder of DFG
  - The acquisition was accounted for as a **Reverse Acquisition**.

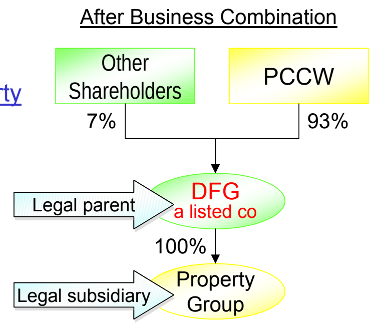
1. Reverse Acquisition

Case

PCCW

2004 Annual Report of DFG (now PCPD Ltd.) stated that:

- For accounting purposes, the Property Group is treated as the acquirer while DFG is deemed to have been acquired by the Property Group
- DFG's consolidated financial statements have been prepared as a continuation of the consolidated financial statements of the Property Group



1. Reverse Acquisition

Case

PCCW

i) the assets and liabilities of the Property Group are recognised and measured at the date of acquisition at their historical carrying values prior to the transaction;

ii) the surplus/deficit and other equity balances recognised in these consolidated financial statements are the surplus/deficit and other equity balances of the Property Group;

iii) the amount recognised as issued equity, consists of share capital and share premium, has been determined by adding to the issued equity of the Property Group immediately before the transaction the cost of the acquisition of the DFG Group.
However, the equity structure (i.e. the no. and type of shares issued) reflects the equity structure of the Co. (DFG or PCPD) including the shares issued in effecting the transaction; and

iv) comparative information presented is that of the Property Group ……

1. Reverse Acquisition

Case

PCCW

Brief proforma financial information can be found in the last 2 pages of the answer pack. In particular:

Any goodwill or negative goodwill arising on the Transaction will be determined as the excess or deficit of

- the purchase consideration deemed to be incurred by the Property Group over
- the fair value of the separable assets and liabilities of the DFG Group at the date of Completion.

The purchase consideration deemed to be given by the Property Group is

- the fair value of the proportion of the Property Group at the date of Completion given up to the existing shareholders of DFG.

The assets and liabilities of the Property Group will be recorded in the balance sheet of the Enlarged DFG Group at their historical carrying value on the books of the Property Group.

1. Reverse Acquisition

Case

PCCW

- For issued equity, 2004 Annual Report of DFG (now PCPD Ltd.) further stated that:
  - Due to the use of reverse acquisition basis of accounting, the amount of issued equity, which includes share capital and share premium in the consolidated balance sheet,
    - represents the amount of issued equity of the legal subsidiary, Ipswich Holdings Limited.
  - The equity structure (i.e. the number and type of shares)
    - reflects the equity structure of the legal parent, Pacific Century Premium Developments Limited.

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2. Combination Achieved In Stages

Changes in a group

1. Reverse acquisition
2. Business combination achieved in stages (Step acquisition)

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2. Combination Achie

Remember this
Critical Amendment

- Recognising and measuring goodwill or a gain from a bargain purchase

Application of the method

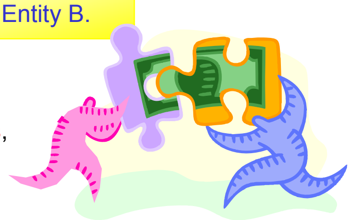
- The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
  a) the aggregate of:
     i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
     ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and
     iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
  b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with HKFRS 3. (HKFRS 3.32)

2. Combination Achieved In Stages

- Additional guidance
  – Amended practices on business combination achieved in stages

- An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date.

- For example,
  – On 31 Dec. 2008, Entity A holds a 35% non-controlling equity interest in Entity B.
  – On that date, Entity A purchases an additional 40 % interest in Entity B, which gives it control of Entity B.



- HKFRS 3 refers to such a transaction as
  – **a business combination achieved in stages**, or sometimes as
  – **a step acquisition**. (HKFRS 3.41)

2. Combination Achieved In Stages

- Additional guidance
  – Amended practices on business combination achieved in stages

- In a business combination achieved in stages, the acquirer shall
  – remeasure its previously held equity interest in the acquiree **at its acquisition-date fair value** and
  – recognise the resulting gain or loss, if any, in profit or loss. (HKFRS 3.42)

2. Combination Achieved In Stages

- Additional guidance
  – Amended practices on business combination achieved in stages

- In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (for example, because the investment was classified as available for sale).
  – If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest. (HKFRS 3.42)

- In other words, "the amount recognised directly in other comprehensive income is reclassified and included in the calculation of the gain or loss recognised in profit or loss". (KPMG-UK, 2008.01)

2. Combination Achieved In Stages

Example

On 1.1.2010	Parent P	Sub S
Property	$ 0	$ 6,000
Investment	0	0
Cash at bank	30,000	2,000
	30,000	8,000
Issued equity	$ (30,000)	$ (5,000)
Retained earnings	0	(3,000)
	(30,000)	(8,000)

On 1.1.2010

- Parent P acquired 20% interest in Subsidiary S at $3,500 by cash.
- Fair value of the property of S was $8,000.

During 2010

- Parent P reported nil profit and profit of S was HK$6,000 (became cash).
- Fair value of S is HK$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2011

- P acquired additional 60% interest in S at $22,000 by cash.
- Fair value of the property of S was $11,000.

2. Combination Achieved In Stages

You would miss this ……

Example

	1st Transaction 1.1.2010	2nd Transaction 1.1.2011	Total
Cost of combinations (or investments)	3,500	22,000	25,500
Fair value information			
Property, at fair value	8,000	11,000	
Cash	2,000	2,000	
Cash (profit for the year)	0	6,000	
	10,000	19,000	
Ownership interest	20%	60%	80%
Share of fair value	2,000	11,400	
Goodwill	1,500	10,600	12,100

2. Combination Achieved In Stages

Example

On 1.1.2010	Parent P	Sub S
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Investment	0	0
Cash at bank	30,000	2,000
	30,000	8,000
Issued equity	$ (30,000)	$ (5,000)
Retained earnings	0	(3,000)
	(30,000)	(8,000)

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During 2010

- Parent P reported nil profit and profit of S was HK$6,000 (became cash).
- Fair value of S is HK$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2011

- P acquired additional 60% interest in S at $22,000 by cash.
- Fair value of the property of S was $11,000.

2. Combination Achieved In Stages

Example

- Firstly, the acquirer (i.e. P) shall
  - remeasure its previously held equity interest in the acquiree (i.e. S) at its acquisition-date fair value and
  - recognise the resulting gain or loss, if any, in profit or loss.
- On 1.1.2011, P acquired additional 60% interest in S at $22,000 by cash
  - It implies that previously held equity interest of 20% (acquired on 1.1.2010) should have a fair value of $7,333 ($22,000 ÷ 60% × 20%)
  - The resulting gain should be recognised in profit or loss as follows:

		Dr($)	Cr($)
Dr	Investment ($7,333 – $6,000)	1,333	
Cr	Profit or loss		1,333

To remeasure the previously held 20% in S at acquisition-date fair value

2. Combination Achieved In Stages

Example

The calculation approach would be revised as ……

			NCI at old approach
			New 1
a(i)	**Consideration transferred**		22,000
a(ii)	**Non-controlling interest (NCI)**	($19K x 20%)	3,800
a(iii)	**Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree**		7,333
			33,133
b.	**Acquisition-date amount of net identifiable assets**		
	Property, at fair value		11,000
	Cash		2,000
	Cash (profit for the year)		6,000
			19,000
Goodwill			**14,133**

2. Combination Achieved In Stages

Example

Consolidation journals (for NCI at old approach):

		Dr($)	Cr($)
Dr	Property – fair value adjustment ($11,000 - $6,000)	5,000	
	Issued equity – subsidiary (given)	5,000	
	Retained earnings – subsidiary (given)	9,000	
	Goodwill (as calculated in last slide)	14,133	
Cr	Investment ($7,333 + $22,000)		29,333
	Non-controlling interest ($19,000 x 20%)		3,800

To recognise the goodwill and eliminate the investments with the equity shares

2. Combination Achieved In Stages

Example

The calculation approach would be revised as ……

		NCI at old approach		NCI at fair value
		New 1		**New 2**
a(i)	**Consideration transferred**	22,000		22,000
a(ii)	**Non-controlling interest (NCI)**	($19K x 20%) 3,800		($22K ÷ 60% x 20%) 7,333
a(iii)	**Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree**	7,333		7,333
		33,133		36,666
b.	**Acquisition-date amount of net identifiable assets**			
	Property, at fair value	11,000		11,000
	Cash	2,000		2,000
	Cash (profit for the year)	6,000		6,000
		19,000		19,000
Goodwill		**14,133**		**17,666**

2. Combination Achieved In Stages

Example

Consolidation journals (for NCI at fair value):

		Dr($)	Cr($)
Dr	Property – fair value adjustment ($11,000 - $6,000)	5,000	
	Issued equity – subsidiary (given)	5,000	
	Retained earnings – subsidiary (given)	9,000	
	Goodwill (as calculated in last slide)	17,666	
Cr	Investment ($7,333 + $22,000)		29,333
	Non-controlling interest ($22,000 ÷ 60% x 20%)		7,333

To recognise the goodwill and eliminate the investments with the equity shares

2. Combination Achieved In Stages

Example

On 1.1.2011	Parent P	Sub S	Old	New 1	New 2
Property	$ 0	$ 6,000	$ 11,000	$ 11,000	$ 11,000
Goodwill	0	0	12,100	14,133	17,666
Investment	28,000	0	0	0	0
Cash at bank	4,500	8,000	12,500	12,500	12,500
	32,500	14,000	35,600	37,633	41,166
Issued equity	$ (30,000)	$ (5,000)	$(30,000)	$(30,000)	$(30,000)
Retained earnings	(2,500)	(9,000)	(1,200)	(3,833)	(3,833)
Revaluation reserves	0	0	(600)	0	0
Non-controlling int.	0	0	(3,800)	(3,800)	(7,333)
	(32,500)	(14,000)	(35,600)	(37,633)	(41,166)

2. Combination Achieved In Stages

Disclosure

For acquisition, the disclosure requirements are mainly set out in HKFRS 3 with the following objectives:

- The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either:
  - a) during the current reporting period; or
  - b) after the end of the reporting period but before the financial statements are authorised for issue..

2. Combination Achieved In Stages

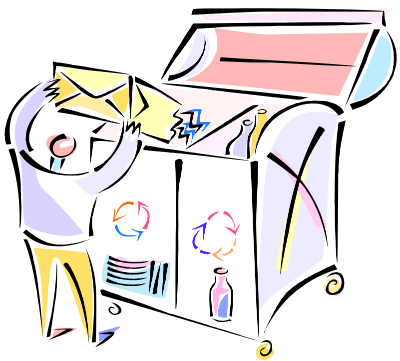
Disclosure

In addition to other information, HKFRS 3 specifically requires an acquirer to disclose the following information for each business combinations achieved in stages that occurs during the reporting period :

i) the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date; and

ii) the amount of any gain or loss recognised as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see HKFRS 3.42) and the line item in the statement of comprehensive income in which that gain or loss is recognised.

3. Disposal – Cease To Control



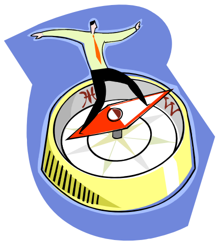
Changes in a group

1. Reverse acquisition
2. Business combination achieved in stages (Step acquisition)
3. Disposal
   a. Full disposal
   b. Partial disposal
   c. Deemed disposal
   d. Business disposal

Foreign exchange difference to be discussed next time

3. Disposal – Cease To Control

- Most critical ……
  - Changes in a parent's ownership interest in a subsidiary that do not result in a loss of control
    - are accounted for **as equity transactions** (i.e. transactions with owners in their capacity as owners)
    - i.e. no gain or loss on disposal of interests in subsidiary can be recognised in profit or loss if the subsidiary is still a subsidiary.



- In such circumstances the carrying amounts of the controlling and non-controlling interests shall be adjusted to reflect the changes in their relative interests in the subsidiary.
- Any difference between
  - the amount by which the non-controlling interests are adjusted and
  - the fair value of the consideration paid or received

  shall be recognised directly in equity and attributed to the owners of the parent.

3. Disposal – Cease To Control

- Specific requirements introduced when a parent loses control of a subsidiary:
  - If a parent loses control of a subsidiary, it:
    a) derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;
    b) derecognises the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them);
    c) recognises:
       i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control; and
       ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;

3. Disposal – Cease To Control

- Specific requirements introduced when a parent loses control of a subsidiary:
  - If a parent loses control of a subsidiary, it:
    - d) recognises any investment retained in the former subsidiary at its fair value at the date when control is lost;
    - e) reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other HKFRSs, the amounts identified in HKAS 27.35 (discussed in next slide); and
    - f) recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.

3. Disposal – Cease To Control

- If a parent loses control of a subsidiary,
  - the parent shall account for all amounts recognised in other comprehensive income in relation to that subsidiary
    - on the same basis as would be required if the parent had directly disposed of the related assets or liabilities.
- Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities,
  - the parent reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary.

3. Disposal – Cease To Control

Example

A parent loses control of a subsidiary and the subsidiary has the following assets:

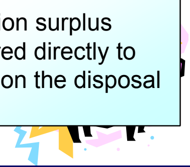
– The subsidiary has available-for-sale financial assets

The parent shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets.

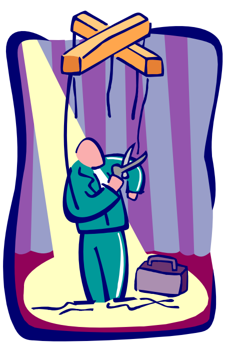
– The subsidiary has property, plant and equipment with revaluation surplus previously recognised in other comprehensive income

The parent transfers the revaluation surplus directly to retained earnings when it loses control of the subsidiary

- since the revaluation surplus would be transferred directly to retained earnings on the disposal of the asset



3. Disposal – Cease To Control



- On the loss of control of a subsidiary, any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary shall be accounted for in accordance with other HKFRSs from the date when control is lost.
- The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with
  - HKAS 39 *Financial Instruments: Recognition and Measurement* or,
  - when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

3. Disposal – Cease To Control

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

On 1.1.2011	**Parent P**	**Sub S**	**J#1**	**J#2**	**Consolidated**
Property	$ 0	$ 6,000		5,000	$ 11,000
Goodwill	0	0		14,133	14,133
Investment	28,000	0	(1,333)	(29,333)	0
Cash at bank	4,500	8,000			12,500
	32,500	14,000			37,633
Issued equity	$ (30,000)	$ (5,000)		5,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	1,333	9,000	(3,833)
Non-controlling int.	0	0		(3,800)	(3,800)
	(32,500)	(14,000)			(37,633)

Carrying amount of Subsidiary S include P's share of FV of property and cash.

3. Disposal – Full Disposal

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

- Assume P disposes of all its 80% interest in S at $35,000 at 2.1.2006

On company level:

Sales proceed		$ 35,000
Cost of investments		(28,000)
Gain on disposal		*7,000*

On consolidated level:

Sales proceed		$ 35,000
Carrying amount as of the date of disposal		
• Fair value of property and cash (11,000 + 8,000)	$ 19,000	
• Non-controlling interest	(3,800)	
• Goodwill	14,133	(29,333)
Gain on disposal		*5,667*

3. Disposal – Full Disposal

Example

On 1.1.2011

	Parent P *After taking up the gain at co level*
Cash at bank (4,500+35,000)	$ 39,500
Issued equity	$ (30,000)
Retained earnings (2,500+7,000)	(9,500)
	(39,500)

3. Disposal – Full Disposal

Example

On 1.1.2011

	Parent P *After taking up the gain at co level*
Cash at bank (4,500+35,000)	$ 39,500
Issued equity	$ (30,000)
Retained earnings (2,500+7,000)	(9,500)
	(39,500)

Reconciliation of consol. retained earnings

Balance b/f	$ 3,833
Gain on disposal	5,667
	9,500

3. Disposal – Partial Disposal

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

- Assume P disposes of its one-forth interests in S at $14,000 at 2.1.2011.
- P still holds 60% interest in S after the disposal.

On company level:		
Sales proceed		$ 14,000
Cost of investments ($28,000 ÷ 4)		(7,000)
Gain on disposal		*7,000*
On consolidated level:		
Sales proceed		$ 14,000
Carrying amount as of the date of disposal		
• Fair value of property and cash (11,000 + 8,000)	$ 19,000	
• Non-controlling interest	(3,800)	
• Goodwill	14,133	
	29,333	
Percentage of holding disposed of	25%	
		(7,333)
Gain on disposal		*6,667*

3. Disposal – Partial Disposal

Example

Journal on P's company level:

		Dr($)	Cr($)
Dr	Cash	14,000	
Cr	Investment		7,000
	Retained earnings (recognised in profit or loss)		7,000

To recognise the gain on disposal of interest in S at company level

3. Disposal – Partial Disposal

Example

On 1.1.2011	Parent P	Sub S	Consolidated *(before disposal)*
Property	$ 0	$ 6,000	$ 11,000
Goodwill	0	0	14,133
Investment (28,000 – 7,000)	21,000	0	0
Cash at bank (4,500 + 14,000)	18,500	8,000	12,500
	39,500	14,000	37,633
Issued equity	$ (30,000)	$ (5,000)	$ (30,000)
Retained earnings (2,500 + 7,000)	(9,500)	(9,000)	(3,833)
Non-controlling interest	0	0	(3,800)
	(39,500)	(14,000)	(37,633)

3. Disposal – Partial Disposal

Example

Consolidation journals:

		Dr($)	Cr($)
Dr	Investment	1,333	
Cr	Retained earnings		1,333

To remeasure the initial (previously held) 20% investment in Subsidiary S at acquisition-date fair value

		Dr($)	Cr($)
Dr	Property – fair value adjustment (as before)	5,000	
	Issued equity – subsidiary (as before)	5,000	
	Retained earnings – subsidiary (as before)	9,000	
	Retained earnings (loss taken up $6,667 – $7,000)	**333**	
	Goodwill (net of written-off portion: $14,133 ÷ 4 x 3)	10,600	
Cr	Investment (29,333 – 7,000)		22,333
	Non-controlling interest (19,000 x 40%)		7,600

No control lost, hence no P/L effect

To recognise the goodwill and eliminate the investments with the equity shares

3. Disposal – Partial Disposal

Example

On 1.1.2011	Parent P	Sub S	J#1	J#2	Consolidated (after disposal)
Property	$ 0	$ 6,000		5,000	$ 11,000
Goodwill	0	0		10,600	10,600
Investment	21,000	0	1,333	(22,333)	0
Cash at bank	18,500	8,000			26,500
	39,500	14,000			48,100
Issued equity	$ (30,000)	$ (5,000)		5,000	$ (30,000)
Retained earnings	(9,500)	(9,000)	(1,333)	9,333	(10,500)
Non-controlling int.	0	0		(7,600)	(7,600)
	(39,500)	(14,000)			(48,100)

3. Disposal – Partial Disposal

Example

On 1.1.2011	Parent P	Sub S	Consolidated (before disposal)		Consolidated (after disposal)
Property	$ 0	$ 6,000	$ 11,000		$ 11,000
Goodwill	0	0	14,133	*÷ 4 x 3 =*	10,600
Investment	21,000	0	0		0
Cash at bank	18,500	8,000	12,500		26,500
	39,500	14,000	37,633		48,100
Issued equity	$ (30,000)	$ (5,000)	$ (30,000)		$ (30,000)
Retained earnings	(9,500)	(9,000)	(3,833)	*+ (6,667)*	(10,500)
Non-controlling int.	0	0	(3,800)	*+ (3,800)*	(7,600)
	(39,500)	(14,000)	(37,633)		(48,100)

3. Disposal – Deemed Disposal

- Deemed disposal is the case that
  - The parent itself has not disposed of any interest in the subsidiary
  - But the subsidiary has issued new shares to the third parties
  - Alternatively, the subsidiary may have issued convertible notes to third parties and the parties have exercise the convertible options
  - As a result, the parent's interest in the subsidiary is reduced.
- Then, gain or loss on the deemed disposal will be ascertained in the consolidated financial statements
  - By comparing the parent's original share of the carrying amount of the subsidiary in the consolidated financial statements with
  - The parent's diluted interest in the subsidiary after the share issues.

3. Disposal – Deemed Disposal

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

- Assume S had 5,000 shares outstanding and issued 1,000 shares to the market at $8 each.
- However, P had not subscribed the new issues of S.

On consolidated level:

	Before new issue		After new issue	
Fair value of property	11,000		11,000	
Cash	8,000	+ 8,000 =	16,000	
	19,000		27,000	
Percentage of holding				
• Original shares held (80%)	4,000		4,000	
• Total shares	5,000		6,000	
• Percentage implied	80%		66.67%	
Share of fair value of net assets	15,200		18,000	
Gain on deemed disposal before goodwill write-off				***2,800***
Goodwill write-off (14,133 ÷ 80% x 13.33%)				***(2,356)***
Gain on deemed disposal				***444***

3. Disposal – Deemed Disposal

Example

On 1.1.2011	Parent P	Sub S	Consolidated *(before disposal)*
Property	$ 0	$ 6,000	$ 11,000
Goodwill	0	0	14,133
Investment	28,000	0	0
Cash at bank	4,500	16,000	12,500
	32,500	22,000	37,633
Issued equity	$ (30,000)	$ (13,000)	$ (30,000)
Retained earnings	(2,500)	(9,000)	(3,833)
Non-controlling int.	0	0	(3,800)
	(32,500)	(22,000)	(37,633)

3. Disposal – Deemed Disposal

Example

Consolidation journals:

		Dr($)	Cr($)
Dr	Investment	1,333	
Cr	Retained earnings		1,333

To remeasure the initial (previously held) 20% investment in Subsidiary S at acquisition-date fair value

		Dr($)	Cr($)
Dr	Property – fair value adjustment (as before)	5,000	
	Issued equity (as before + 8,000 new issues)	13,000	
	Retained earnings (as before)	9,000	
	Goodwill (net of written-off portion: 14,133 – 2,356)	11,777	
Cr	Investment		29,333
	Non-controlling int. (FV of net assets: 27,000 x 33.33%)		9,000
No P/L effect	**Retained earnings** ***(gain on deemed disposal)***		**444**

To recognise the goodwill and eliminate the investments with the equity shares

3. Disposal – Deemed Disposal

Example

On 1.1.2011	Parent P	Sub S	J#1	J#2	Consolidated (after disposal)
Property	$ 0	$ 6,000		5,000	$ 11,000
Goodwill	0	0		11,777	11,777
Investment	28,000	0	1,333	(29,333)	0
Cash at bank	4,500	16,000			20,500
	32,500	22,000			43,277
Issued equity	$ (30,000)	$ (13,000)		13,000	$ (30,000)
Retained earnings	(2,500)	(9,000)	(1,333)	8,556	(4,277)
Non-controlling int.	0	0		(9,000)	(9,000)
	(32,500)	(22,000)			(43,277)

NCI is now = FV of net assets x new NCI% = $27,000 x 33.33% = $9,000

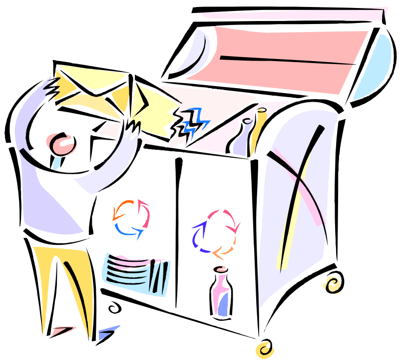
3. Disposal – Deemed Disposal

Example

On 1.1.2011	Parent P	Sub S	Consolidated (before disposal)		Consolidated (after disposal)
Property	$ 0	$ 6,000	$ 11,000		$ 11,000
Goodwill	0	0	14,133	- 2,356	11,777
Investment	28,000	0	0		0
Cash at bank	4,500	16,000	12,500		20,500
	32,500	22,000	37,633		43,277
Issued equity	$ (30,000)	$ (13,000)	$ (30,000)		$ (30,000)
Retained earnings	(2,500)	(9,000)	(3,833)	+ (444)	(4,277)
Non-controlling int.	0	0	(3,800)		(9,000)
	(32,500)	(22,000)	(37,633)		(43,277)

NCI is now = FV of net assets x new NCI% = $27,000 x 33.33% = $9,000

3. Disposal – Cease To Control



Changes in a group

1. Reverse acquisition
2. Business combination achieved in stages (Step acquisition)
3. Disposal
   a. Full disposal
   b. Partial disposal
   c. Deemed disposal
   d. Business disposal

3. Disposal – Business Disposal

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

- Assume S mainly involved in holding investment property to derive rental and had 2 properties managed independently.
- On 2.1.2011, S disposed of one property at $8,000 (cost $3,000) and the remaining property's recoverable amount was $14,000 (cost $3,000).

On company level of S:	
Sales proceed of property	$ 8,000
Cost of property	(3,000)
Gain on disposal	$ 5,000
On consolidated level:	
Sales proceed of property	$ 8,000
Cost of property to the group (11,000 ÷ 22,000 x 8,000)	(4,000)
Gain on disposal at group level	$ 4,000

That's all?

3. Disposal – Business Disposal

Allocating Goodwill to CGU → Disposal

- If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit
  - the goodwill associated with the operation disposed of shall be:
    a) included in the carrying amount of the operation
      - when determining the gain or loss on disposal; and
    b) measured on the basis of the relative values of
      - the operation disposed of, and
      - the portion of the unit retained,

    unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

3. Disposal – Business Disposal

Example

Allocating Goodwill to CGU → Disposal

- An entity sells for \$100 an operation that was part of a CGU to which goodwill has been allocated. **\$100**
- The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. **\$300**
- The recoverable amount of the portion of the CGU retained is \$300.

- Because the goodwill allocated to the CGU cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of
  - the operation disposed of, and
  - the portion of the unit retained.
- Therefore, 25% of the goodwill (\$100 / \$400) allocated to the CGU is included in the carrying amount of the operation that is sold.

3. Disposal – Business Disposal

Example

Following the Example used in "Business Combination Achieved in Stages" as follows (P holds 80% of S):

- Assume S mainly involved in holding investment property to derive rental and had 2 properties managed independently.
- On 2.1.2011, S disposed of one property at $8,000 (cost $3,000) and the remaining property's recoverable amount was $14,000 (cost $3,000).

On company level of S:	
Sales proceed of property	$ 8,000
Cost of property	(3,000)
Gain on disposal	$ 5,000
On consolidated level:	
Sales proceed of property	$ 8,000
Cost of property to the group ($11,000 ÷ 22,000 x 8,000)	(4,000)
Gain on disposal at group level	$ 4,000
Goodwill written off in accordance with HKAS 36 ($14,133 ÷ 22,000 x 8,000)	**$ 5,139**

3. Disposal – Business Disposal

Example

Original consolidation journals:

		Dr($)	Cr($)
Dr	Investment	1,333	
Cr	Retained earnings		1,333

To remeasure the initial (previously held) 20% investment in Subsidiary S at acquisition-date fair value

		Dr($)	Cr($)
Dr	Property – fair value adjustment ($11,000 - $6,000)	5,000	
	Issued equity – subsidiary (given)	5,000	
	Retained earnings – subsidiary (given)	9,000	
	Goodwill (as calculated in last slide)	14,133	
Cr	Investment		29,333
	Non-controlling interest (19,000 x 20%)		3,800

To recognise the goodwill and eliminate the investments with the equity shares

3. Disposal – Business Disposal

Example

Additional consolidation journals:

		Dr($)	Cr($)
Dr	Profit or loss	1,000	
Cr	Property		1,000

To adjust the gain recognised in S as fair value had been taken up at group level before

		Dr($)	Cr($)
Dr	Profit or loss	800	
Cr	Non-controlling interest (4,000 x 20%)		800

To allocate the gain on disposal of property to non-controlling interest

		Dr($)	Cr($)
Dr	Profit or loss	5,139	
Cr	Goodwill		5,139

To write off the goodwill allocated to the "business" in accordance with HKAS 36

3. Disposal – Business Disposal

Example

On 1.1.2011	Parent P	Sub S	J#1	J#2	J#3	Consolidated
Property	$ 0	$ 3,000		5,000	(1,000)	$ 7,000
Goodwill	0	0		14,133	(5,139)	8,994
Investment	28,000	0	1,333	(29,333)		0
Cash at bank	4,500	16,000				20,500
	32,500	19,000				36,494
Issued equity	$ (30,000)	$ (5,000)		5,000		$ (30,000)
Retained earnings	(2,500)	(14,000)	(1,333)	9,000	6,939	(1,894)
Non-controlling int.	0	0		(3,800)	(800)	(4,600)
	(32,500)	(19,000)				(36,494)

3. Disposal – Cease To Control

Wait a minute?

Changes in a group

1. Reverse acquisition
2. Business combination achieved in stages (Step acquisition)
3. Disposal
   a. Full disposal
   b. Partial disposal
   c. Deemed disposal
   d. Business disposal

Are they disposal of business?

4. Merger Accounting

4. Merger Accounting

Scope → **All, but except for 3 types**

- HKFRS 3 applies to a transaction or other event that meets the definition of a business combination.
- HKFRS 3 does not apply to:
  a) the formation of a joint venture.
  b) the acquisition of an asset or a group of assets that does not constitute a business.
    - Brief requirements set out for such acquisition and it does not give rise to goodwill
  c) a combination of entities or businesses under common control.

Common Control

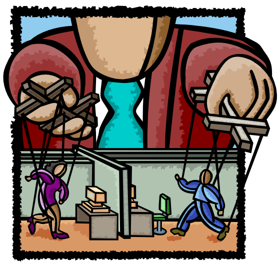
4. Merger Accounting

Scope → **All, but except for 3 types**

Common control combination is one of the 3 types

In addressing such combination out the scope of HKFRS 3, HKICPA issued

- HK Accounting Guideline 5 *Merger Accounting for Common Control Combinations* (AG 5)
- SSAP 27 was then withdrawn.



4. Merger Accounting

Scope → All, but except for 3 types

Termed as **Common Control Combinations**

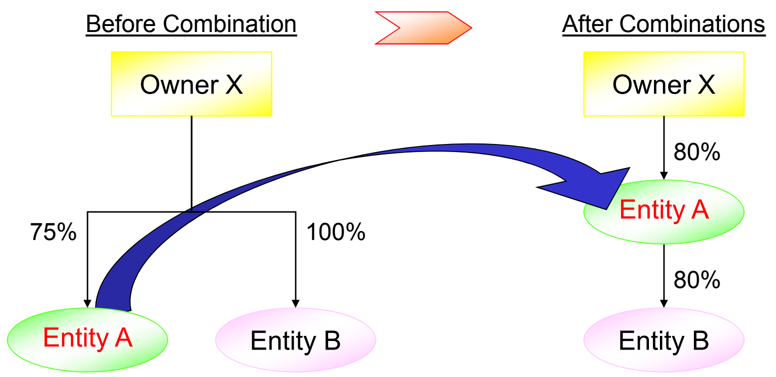
A business combination involving entities or businesses under common control is
- a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties
- both before and after the business combination, and
- that control is not transitory.

Thus, a business combination is outside the scope of HKFRS 3 when
- the same group of individuals has, as a result of contractual arrangements, ultimate collective power to govern the financial and operating policies of each of the combining entities so as to obtain benefits from their activities, and
- that ultimate collective power is not transitory.

4. Merger Accounting

Example

Termed as **Common Control Combinations**

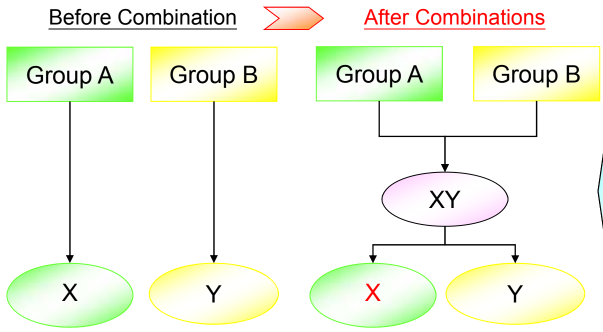


4. Merger Accounting

Example

Are the following business combinations involving entities or businesses under common control?

- Group A holds 100% interest in X and Group B holds 100% interest in Y
- Both groups have agreed to pool together X and Y and formed as new company XY to hold 100% interest in X and Y



Not under common control → still within scope of HKFRS 3

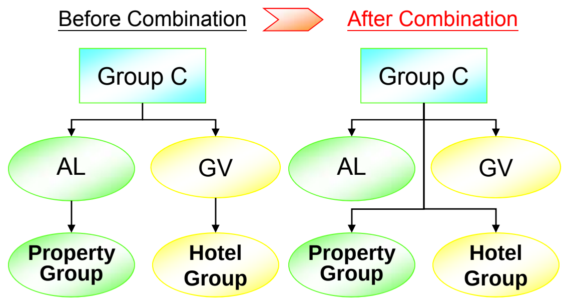
- X and Y are not ultimately controlled by the same party or parties both before and after the business combination

4. Merger Accounting

Example

Are the following business combinations involving entities or businesses under common control?

- Group C holds 60% interest in AL and 75% interest in GV
  - AL holds 80% interest in a property group
  - GV holds 60% interest in an hotel group
  - Group C decided to acquired AL's interest in its property group and GV's interest in its infrastructure group



Under common control → not within scope of HKFRS 3

- Both AL and GV are ultimately controlled by the same party, Group C, before and after the business combination

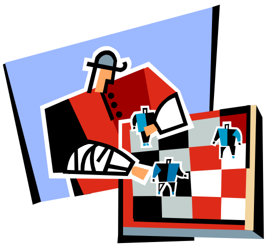
4. Merger Accounting

- Common control combinations as referred in AG 5 are outside the scope of HKFRS 3
- AG 5 clarifies that
  - HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* contains requirements for the selection of accounting policies
    - in the absence of a Standard or an Interpretation that specifically applies to an issue.
- AG 5 further states that
  - 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. Merger Accounting

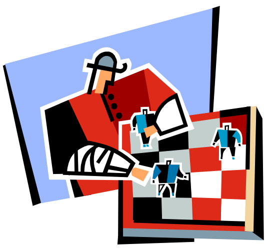
- AG 5 sets out
  - the basic principles and procedures of merger accounting when recognising a common control combination.
  - If there is any inconsistency between AG 5 and any HKFRS (or Interpretation), that HKFRS (or Interpretation) is to be followed.
- Certain HKFRSs may contain guidance or requirements 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 addresses consolidation principles and the treatment of a disposal of a subsidiary and
  - HKAS 37 addresses provisions for restructuring.

4. Merger Accounting



- The basic principles and procedures under AG 5
  - is similar to SSAP 27 (with some minor amendments)
- The “as if” concept underlying the merger accounting still employed in AG 5 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.

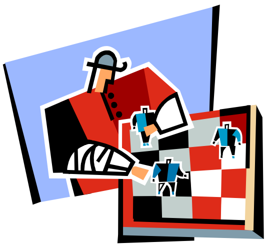
4. Merger Accounting



- 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.

4. Merger Accounting



- 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.
- 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.

4. Merger Accounting

- 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 (negative goodwill) 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, 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.

4. Merger Accounting

Example

On 1.1.2010	Parent P	Sub S
Property	$ 0	$ 6,000
Investment	0	0
Cash at bank	30,000	2,000
	30,000	8,000
Issued equity	$ (30,000)	$ (5,000)
Retained earnings	0	(3,000)
	(30,000)	(8,000)

On 1.1.2010

- Parent P acquired 20% interest in Subsidiary S at $3,500 by cash.
- Fair value of the property of S was $8,000.

During 2010

- Parent P reported nil profit and profit of S was HK$6,000 (became cash).
- Fair value of S is HK$30,000 at year-end.
- P accounted for S as held for trading.

On 1.1.2011

- P acquired additional 60% interest in S at $22,000 by cash.
- Fair value of the property of S was $11,000.

4. Merger Accounting

Example

On 1.1.2011	Parent P	Sub S	Old	New 1
Property	$ 0	$ 6,000	$ 11,000	$ 11,000
Goodwill	0	0	12,100	14,133
Investment	28,000	0	0	0
Cash at bank	4,500	8,000	12,500	12,500
	32,500	14,000	35,600	37,633
Issued equity	$ (30,000)	$ (5,000)	$(30,000)	$(30,000)
Retained earnings	(2,500)	(9,000)	(1,200)	(3,833)
Revaluation reserves	0	0	(600)	0
Non-controlling int.	0	0	(3,800)	(3,800)
	(32,500)	(14,000)	(35,600)	(37,633)

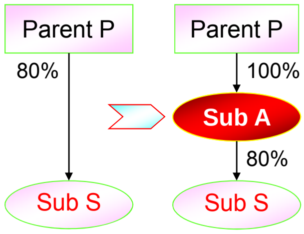
- On 5 January 2011, new shares of $30,000 by Parent P are issued at par
- Parent P sets up a new 100% owned Subsidiary A by injecting $30,000 as share capital of Subsidiary A.
- Subsidiary A in turn acquires Parent P's interest in Subsidiary S at $30,000.

Try this ……

…ccounting

Example

On 5.1.2011	**Parent P**	**Sub S**	**Sub A**
Property	$ 0	$ 6,000	$ 0
Goodwill	0	0	0
Investment	30,000	0	30,000
Cash at bank	34,500	8,000	0
	64,500	14,000	30,000
Issued equity	$ (60,000)	$ (5,000)	$ (30,000)
Retained earnings	(4,500)	(9,000)	0
Revaluation reserves	0	0	0
Non-controlling int.	0	0	0
	(64,500)	(14,000)	(30,000)



Dr	Investment in Sub A	30,000	
Cr	Investment in Sub S		28,000
	Gain on disposal of investment		2,000

To account for the disposal on company level

Please prepare the consolidated balance sheet of Sub. A as at 5.1.2006 after the above transactions

- By using purchase method under HKFRS 3
- By using merger accounting under AG 5

4. Merger Accounting

Example

Consolidation journal by using purchase method:

	5.1.2006
Consideration	30,000
Non-controlling int.	3,800
	33,800
Fair value information	
Property, at fair value	11,000
Cash	8,000
	19,000
Goodwill	14,800

Dr	Property – fair value adj.	5,000	
	Issued equity	35,000	
	Retained earnings	9,000	
	Goodwill	14,800	
Cr	Investment		30,000
	Non-controlling interest		3,800

To recognise the goodwill and eliminate the investments with the equity shares

4. Merger Accounting

Example

On 5.1.2006	Parent P	Sub S	Sub A	J#2	A's consol.
					Purchase method
Property	0	6,000	0	5,000	$ 11,000
Goodwill	0	0	0	14,800	14,800
Investment	30,000	0	30,000	(30,000)	0
Cash at bank	34,500	8,000	0		8,000
	64,500	14,000	30,000		33,800
Issued equity	(60,000)	(5,000)	(30,000)	5,000	$ (30,000)
Retained earnings	(4,500)	(9,000)	0	9,000	0
Non-controlling int.	0	0	0	(3,800)	(3,800)
	(64,500)	(14,000)	(30,000)		(33,800)

4. Merger Accounting

Example

Consolidation journal by using merger accounting:

The "as if" basis is used and no acquisition has been occurred

- As if the combination had occurred from the date when the combining entity first came under the control of Parent P
- Except for those accounted for in Parent P before, no goodwill and fair value adjustment would be additionally created

2 stages in this case

Dr	Property – fair value adjustment	5,000	
	Issued equity – subsidiary	5,000	
	Retained earnings – subsidiary	9,000	
	Goodwill	14,133	
	Other reserves (balancing figure)	667	
Cr	Investment		30,000
	Non-controlling interest		3,800

To account for the combination on an "as-if" basis (as if at Parent P's level)

4. Merger Accounting

Example

On 5.1.2006	Parent P	Sub S	Sub A	J#2	A's consol. *Under Merger*	A's consol. *Purchase*
Property	0	6,000	0	5,000	$ 11,000	$ 11,000
Goodwill	0	0	0	14,133	14,133	14,800
Investment	30,000	0	30,000	(60,000)	0	0
Cash at bank	34,500	8,000	0		8,000	8,000
	64,500	14,000	30,000		33,133	33,800
Issued equity	(60,000)	(5,000)	(30,000)	35,000	$ (30,000)	$ (30,000)
Retained earnings	(4,500)	(9,000)	0	9,667	0	0
Other reserves	0	0	0	0	667	0
Non-controlling int.	0	0	0	(3,800)	(3,800)	(3,800)
	(64,500)	(14,000)	(30,000)		(33,133)	(33,800)

4. Merger Accounting

Case

中國建築國際集團有限公司 CHINA STATE CONSTRUCTION INTERNATIONAL HOLDINGS LIMITED

China State Construction International Holdings Ltd.

- In its 2005 Result Announcement:
  - During the year, the company has acquired the 100% equity interests of China State Construction Engineering (Hong Kong) Ltd. and …… from China Overseas Holdings Ltd.
  - The transactions are accounts for in accordance with the Accounting Guideline 5 "Merger Accounting for Common Control Combinations" (AG 5) issued by HKICPA as the companies involved are under the common control of China State Construction Engineering Corporation.
  - The Group resulting from the above mentioned reorganisation is regarded as a continuing entity.
  - Accordingly, the financial statements of the Group have been prepared using the principle of merger accounting for common control in accordance with AG 5.

4. Merger Accounting

Is it a must to follow Accounting Guideline (AG)?

- Preface to HKFRS states:
  - AGs have effect as <u>guidance statements</u> and <u>indicators of best practice</u>.
  - They are <u>persuasive in intent</u>.
  - Unlike HKFRSs, AGs
    - are <u>not mandatory</u> on members of the HKICPA
    - but <u>are consistent with the purpose of HKFRSs</u> in that they help define accounting practice in the particular area or sector to which they refer.
  - Therefore, they should <u>normally be followed</u> and members of the HKICPA should be <u>prepared to explain departures if called upon to do so</u>.

Consolidated Financial Statements

(Part 2)

22 March 2010

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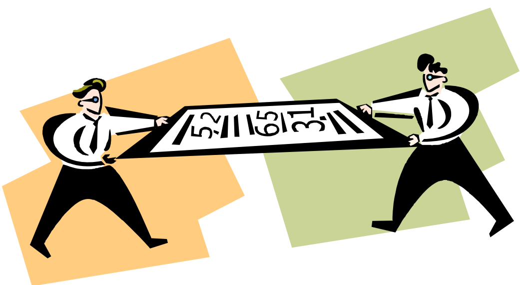

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Consolidated Financial Statements

(Part 2)

22 March 2010

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