

HKICPA Staff Preliminary Views

Scope of the project (Appendix A) – responding to Q1 & Q2 of Discussion Paper

- We support the IASB staff's proposal to consider almost all types of combined structures under common control, and not to restrict the scope, at this stage. The IASB could decide to scope out particular transactions later.
- In 2016, HKICPA studied common control transactions in Hong Kong.
 - ✓ The majority of our transactions are covered within the proposed scope.
 - ✓ Similar questions were raised regarding whether some transactions such as those in the scope paper, are considered a BCUCC.

Question to SWG members

Do you agree or disagree with HKICPA staff preliminary views?

Methods of accounting (Appendix B) – responding to Qs 3 to 5 of Discussion Paper

- In general, we think that the proposed factors identified by IASB staff and the assessment process are appropriate following the principles of the revised Conceptual Framework.
- In addition to the proposed factors, we think that the existence of unrelated NCI in the combining entities should also be considered as they would want to maximise the benefits arising from the transaction, and therefore influence the pricing of the consideration to be based on market. We think that they would pay market consideration only if it is justified by the commercial substance arising from the transaction.
- When we applied the factors and process to the example below, we found that commercial substance is a crucial factor in selecting an appropriate accounting method. Other factors, in particular, the pricing of the consideration, are indicative of the existence of commercial substance. Once commercial substance to the combining entities exists, it is straight forward to select an appropriate accounting method. However, it may be judgmental to determine what should be deemed a significant change in future cashflows for the combining entities, as it may be reliant on management estimates. Nevertheless, we think that information disclosures about the estimates and judgements a company makes in determining the future cashflows would help to increase transparency and usefulness of information for the primary users of financial statements.

Question to SWG members

Do you have comments on HKICPA staff preliminary views (e.g. agree, disagree, other)?

Our preliminary staff views for each factor in selecting an appropriate accounting method are outlined below. Please comment if you agree, disagree or have any other comments.

IASB staff factors	Background of example	HKICPA staff preliminary views
Decision making process	The combination was directed by ultimate controlling party	<p>May not be a crucial factor, because no matter which party initiated or directed the transaction, it is more important to understand the substance in the transaction. However, this factor may be useful to understand the background of the transaction.</p> <p>Furthermore, the decision making process may not be obvious in all circumstances.</p>
Purpose of the transaction	The combination brings benefit to both combining entities and the ultimate controlling party (tax benefit to the controlling party and streamlining operations for the combining entities)	<p>It is an important factor because it is a starting point of evaluating whether or not the transaction has commercial substance. However, we observe that in certain situations it may be challenging to identify the purpose of the transaction, e.g. it may not be obvious whether the controlling party or the combining entities receives more benefits, or if both receives similar benefits.</p> <p><u>Primary users: useful information</u> Combining entities' NCI might want to see the benefits of the combination reflected in the financial statements as the dynamics of combining entities as a reporting group has changed.</p>

IASB staff factors	Background of example	HKICPA staff preliminary views
		<p>The controlling party may already have internal information on the benefits of the transaction and therefore may not care whether the benefits are reflected in the financial statements.</p> <p>This poses a conflict among the primary users.</p>
Commercial substance	<p>Negative cash outflow upon completion of the transaction.</p> <p>Budgeted cash inflow in the future.</p>	<p>We think that every transaction undertaken has commercial substance, although to varying extents. In negotiating the pricing of consideration, the commercial substance (future cashflows of the combining entities), is an important factor in determining the pricing of consideration.</p> <p>The Conceptual Framework requires substance to be faithfully represented in the financial statements. Therefore, we think that this is a crucial factor.</p> <p><u>Primary users: useful information</u></p> <p>External users want to understand what synergies arose from the transaction, for example, changes in future cashflows in the combining entities. Therefore, this needs to be reflected in the financial statements.</p> <p>We understand that some controlling parties would also want to reflect the commercial substance in the financial statements because they would want external investors to understand the synergies arising from the transaction. These are typically listed corporations.</p>

IASB staff factors	Background of example	HKICPA staff preliminary views
		Other controlling parties may be constrained by cost. These are typically private family run companies.
Consideration: Pricing	Reflects fair value	As discussed above, we think that the pricing of the consideration normally reflects the commercial substance of the transaction. Therefore, we think that this is also a crucial factor.
Consideration: Form	50% cash and 50% shares	<p>We think that the pricing of consideration is indicative of the commercial substance in a transaction. The form is not as important as it may depend on the preference of the selling entity, i.e. whether it prefers cash, shares, or a mix of both, or others.</p> <p>Furthermore, from our research on the history of predecessor methods, we observed that the form of consideration was once required to be substantially all shares to qualify for predecessor method. This is because it was deemed to represent a continuity of ownership interests within the group, which was the concept underlying the predecessor method.</p> <p>We also noted historical issues with this factor in that transactions can be easily structured to meet this factor.</p>

Question to SWG members
Do you have comments on HKICPA staff preliminary views (e.g. agree, disagree, other)?