

HKFRS News

Shedding light on the HKICPA's activities

January 2008

In this newsletter...

1. Convergence between China Accounting Standards and Hong Kong Financial Reporting Standards
2. Removal of US GAAP/IFRS reconciliation requirement by US SEC
3. Business Combinations Phase II: IFRS 3 and IAS 27 amendments
4. Contacts

Convergence between China Accounting Standards and Hong Kong Financial Reporting Standards

On 6 December 2007, the China Accounting Standards Committee signed a joint declaration with the Hong Kong Institute of Certified Public Accountants (HKICPA) on China Accounting Standards (CAS) achieving substantial convergence with Hong Kong Financial Reporting Standards (HKFRS).

Pursuant to the joint declaration, financial statements prepared in accordance with CAS effective on 6 December 2007, after adjusting for the reconciliation differences relating to reversal of impairment losses on assets and related party disclosures where applicable, should achieve substantially the same effect as those prepared in accordance with HKFRS effective on the same date. In addition, a mechanism has been established to eliminate the above two differences and to maintain the convergence of CAS and HKFRS on an ongoing basis.

Immediately after the joint declaration, work will be carried out to achieve mutual acceptance by the regulators of one jurisdiction for the purpose of listing in that jurisdiction, the financial statements of an enterprise of the other jurisdiction that are prepared under the accounting standards of that other jurisdiction and audited by eligible auditing practices in that other jurisdiction applying auditing standards of that other jurisdiction.

HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.

© 2008 PricewaterhouseCoopers. All rights reserved.

Removal of US GAAP/IFRS reconciliation requirement by US SEC

In November 2007, the Securities and Exchange Commission (SEC) announced that it is to allow IFRS financial statements from foreign private issuers (FPI) in the US to be accepted without reconciliation to US GAAP.

The SEC said in its announcement that IFRS financial statements would be accepted only if prepared using IFRS as issued by the IASB. It said, "The purpose of the requirement to use the IASB-approved version is to encourage the development of IFRS as a uniform global standard, not a divergent set of standards applied differently in every nation. Consistency of application of IFRS will help US investors who own foreign securities to have better comparability." Consequently, this exemption will not apply to FPIs that prepare financial statements in accordance with HKFRS.

Business Combinations Phase II: IFRS 3 and IAS 27 amendments

The International Accounting Standards Board (IASB) issued amended standards on business combinations and consolidated financial statements as part of the IFRS/US GAAP convergence programme earlier this month. Furthermore, the IASB has decided to postpone the implementation of the standard to 1 July 2009.

The FASB has already amended its standards on business combinations and consolidated financial statements in early December 2007.

Business Combinations Phase II consists mainly of IFRS 3 and IAS 27 amendments. The business combinations standard (IFRS 3R) is identical in principle and language to the FASB's 141R with three exceptions:

- full goodwill;
- reacquired rights; and
- requirements around recognition of contingent assets and contingent liabilities.



This will eliminate almost all of the current differences in the initial accounting for business combinations. But, significant differences will remain in subsequent accounting, driven by different requirements for impairment testing, accounting for contingent assets and liabilities and deferred tax.

The consolidation standard (IAS 27R) has converged in the broad principles although the standards have not been developed using the same language. Differences will remain mainly from the operation of de facto control, FIN 46 and SIC-12.

Changes to IFRS 3

Scope and applicability of IFRS 3R

The business combinations standard represents some significant changes for IFRS but is less of a radical change than the comparable standard in US GAAP.

IFRS 3R is a further development of the acquisition model.

- The standard now applies to more transactions, as combinations by contract alone and combinations of mutual entities are brought into the scope of the standard.

- Common control transactions and the formation of joint ventures remain outside the scope of the standard.
- The definition of a business has been amended slightly to include the phrase 'capable of being managed' rather than 'are managed'. This change is not predicted to pull many more transactions into business combinations from asset deals.
- Acquisition date does not change under IFRS; US GAAP will converge to the existing requirements of IFRS on this point.

Consideration

Consideration is the amount paid for the acquired business. Some of the most significant changes are found in this section of the revised standard and will have the effect of both increasing and decreasing the amount of consideration.

- Transaction costs no longer form a part of the purchase price, they are expensed as incurred.
- Consideration now includes the fair value of all interests that the acquirer may have held in the acquired business (re-evaluation of previously held interests). This includes any interest in an associate or joint venture, option, warrants or other equity interests of the acquired business. If the interests in the target were not held at fair value, the interest is re-measured to fair value with the change recognised in the income statement.
- The requirements for recognition of contingent consideration have also been amended. Contingent consideration is now required to be recognised at fair value even if it is not deemed to be probable of payment at the date of the acquisition. All subsequent changes in contingent consideration are recognised in the income statement, rather than against goodwill as today.

Goodwill and measurement of non-controlling interests

The requirement to recognise 'full goodwill' in a business combination where the acquirer obtains a controlling interest but not 100% of the acquired business was one of the more controversial proposals in

the exposure draft. The revised standard gives entities the **option to measure non-controlling interests** (currently called minority interest) at:

- fair value of identifiable assets and liabilities or
- at full fair value ('full goodwill' option).

The first will result in measurement of goodwill with no difference from existing IFRS 3; the second approach will record goodwill on the non-controlling interest as well as the acquired controlling interest. The 'bargain purchase' guidance remains the same, with the requirement to recognise 'negative goodwill' immediately in the income statement.

Asset and liability valuation

The revised IFRS 3 has limited changes to the assets and liabilities recognised in the acquisition balance sheet.

- The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained. Most assets are recognised at fair value with exceptions for certain items such as deferred tax and pension obligations.
- There is a new requirement to recognise assets subject to contingencies at fair value, similar to the existing guidance to recognise contingent liabilities at fair value.
- There is additional guidance on how to determine whether the assets and liabilities belong to the acquired business or are excluded from the acquisition balance sheet.

Contract classification

The revised standard includes additional guidance with regard to contracts and arrangements of the acquired business at the transaction date.

- Contracts and arrangements are assessed for classification purposes at the transaction date with the exception of leases and insurance contracts.
- Leases and insurance contracts are assessed based on the facts at the time they were entered into (or subject to substantial modification).

Share-based payments

There is additional guidance on accounting for employee shared-based payments in the revised standards. It provides additional specificity on valuation, as well as determination of whether replacement share awards are part of the consideration for the business combination or may be compensation for post-combination services.

Finalisation of initial accounting determined provisionally

The period of time to finalise the purchase accounting remains one year from the date of the transaction.

Deferred tax asset

Current guidance requires deferred tax assets of the combined business that are not recognised at the date of the combination but subsequently to meet the recognition criteria to be adjusted against goodwill. The revised standard will only allow adjustments against goodwill within the one year window for finalisation of the purchase accounting.

Changes to IAS 27

The revised consolidation standard moves IFRS to a mandatory adoption of the economic entity model. The current practice under IFRS is overwhelmingly the parent company approach whereas the economic entity approach treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company.

To sum up:

- purchases and sales of some or all of the non-controlling interest (when control is retained) are treated as **treasury share-type transactions and accounted for in equity**. For instance, a partial disposal of an interest in a subsidiary in which the parent company retains control does not result in a gain or loss but an increase or decrease in equity.
- A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest (say an associate) triggers **recognition of gain or loss on the entire interest**. A realised gain or loss is recognised on the portion that has been disposed of; a holding gain is recognised on the interest retained, calculated as the difference between the fair value and the book value of the retained interest.

Conclusion

The revised standards bring a further iteration of the acquisition accounting model and compulsory adoption of the economic entity approach. The Board has promised 'there is no phase III' but is expected to consider the accounting for common control transactions and puts, calls and forwards (in a business combination) as potential improvements projects.



Contacts

For further help, please contact:

Hong Kong

22/F Prince's Building
Central, Hong Kong
Tel: +852 2289 8888

Beijing

26/F Office Tower A
Beijing Fortune Plaza
7 Dongsanhuan Zhong Road
Chaoyang District
Beijing 100020, PRC
Tel: +86 (10) 6533 8888

Shanghai

11/F PricewaterhouseCoopers Center
202 Hu Bin Road
Shanghai 200021, PRC
Tel: +86 (21) 6123 8888

Chongqing

Room 1905
19/F Metropolitan Tower
68 Zou Rong Road
Chongqing 400010, PRC
Tel: +86 (23) 6393 7888

Dalian

8/F Senmao Building
147 Zhongshan Road
Xigang District
Dalian 116011, PRC
Tel: +86 (411) 8379 1888

Guangzhou

25/F Center Plaza
161 Lin He Xi Road
Guangzhou 510620, PRC
Tel: +86 (20) 3819 2000

Macau

28/F Unit C
Bank of China Building
Avenida Doutor Mario Soares
Macau
Tel: +853 8799 5111

Qingdao

4601 Qingdao International Finance Center
59 Hong Kong Middle Road
Qingdao 266071, PRC
Tel: +86 (532) 8089 1888

Shenzhen

38/F Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008, PRC
Tel: +86 (755) 8261 8888

Suzhou

Room 1501
Genway Tower
188 Wang Dun Road
Suzhou Industrial Park
Suzhou 215028, PRC
Tel: +86 (512) 6273 1888

Tianjin

17/F The Exchange Tower One
189 Nanjing Road, Heping District
Tianjin 300051, PRC
Tel: +86 (22) 2330 6789

Xi'an

Room 728
Zhongda International Mansion
30 Nan Da Street
Xi'an 710002, PRC
Tel: +86 (29) 8720 3336

<http://www.pwchk.com>

<http://www.pwc.com/ifrs>