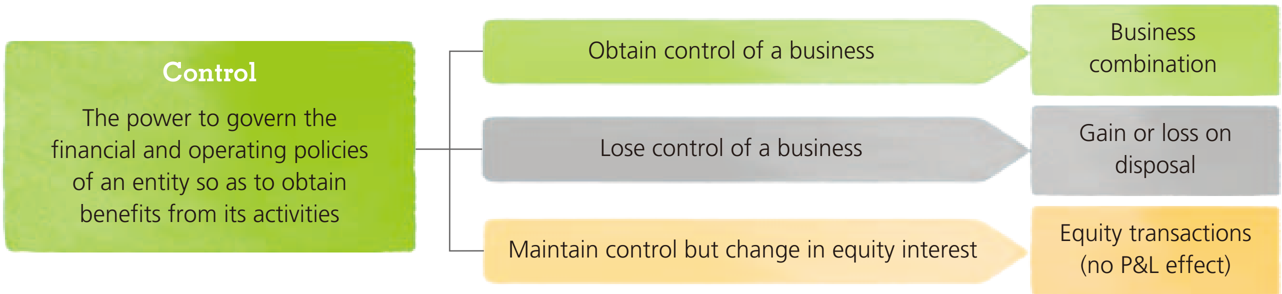
Business Combinations

The scale of CLP's business in Australia grew substantially after the acquisition of the EnergyAustralia retail business, the Delta Western GenTrader contracts and the power station development sites in New South Wales (NSW) (the "NSW Acquisition"). The NSW Acquisition is classified as a business combination under HKFRS 3 Business Combinations. A detailed disclosure has been made in Note 2 to the Financial Statements. HKFRS 3 and its related standards have significant implications on business acquisitions and disposals which, we believe, deserve further explanation in this year's "Accounting Mini-series".

What is the difference between a business combination and an asset acquisition? Why is it important to distinguish them?

From an accounting perspective, an acquisition of a business is accounted for differently from an asset acquisition. A business combination is a transaction in which the acquirer obtains control of one or more businesses (subject business). HKFRS 3 provides guidance that "a business consists of inputs and processes applied to those inputs that have the ability to create outputs". The NSW Acquisition has been evaluated to consist of inputs (customer contracts, commodity contracts and intellectual property), processes (via the Transition Services Agreement with the vendor) and outputs (energy sales) and is therefore concluded to be a business combination. In contrast, our acquisition of a 20% working level interest in Eastern Star Gas in Australia is treated as an asset acquisition.

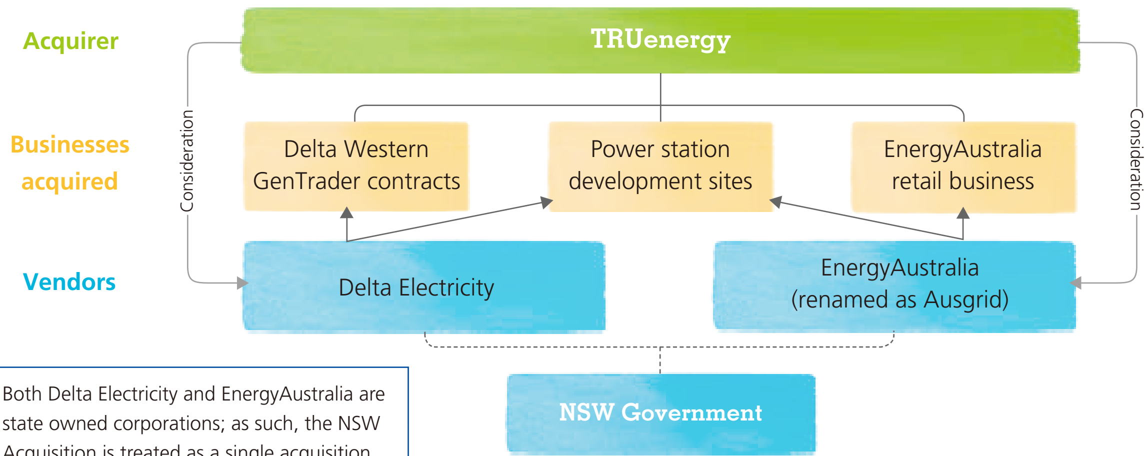


The acquisition method

The NSW Acquisition is accounted for in the Group's financial statements by using the acquisition method. This method governs the recognition and measurement of the assets acquired, liabilities assumed, consideration transferred and goodwill on the date of acquisition. The following is a step by step illustration of how the acquisition method is applied on this transaction. Are you ready to go?

Step 1: Identify the acquirer

The acquirer is the entity that obtains control over one or more other entities or businesses. It may not be a straightforward process for some complex transactions such as a reverse acquisition. A reverse acquisition occurs when the acquirer in form is identified as the "subject business" in substance for accounting purposes.



Both Delta Electricity and EnergyAustralia are state owned corporations; as such, the NSW Acquisition is treated as a single acquisition.

Step 2: Determine the acquisition date

Determining the acquisition date is critical as the fair value of the consideration paid, assets acquired and liabilities assumed are measured on that date. This is also the date from when the results of the acquired business are consolidated into the financial statements of the acquirer.

The acquisition date is the date on which the acquirer obtains control of the subject business. This may or may not correspond to the date when an agreement is entered, or consideration is paid. As per HKFRS 3, the assets and liabilities booked at the acquisition date are provisional and subject to refinement for up to 12 months after acquisition.

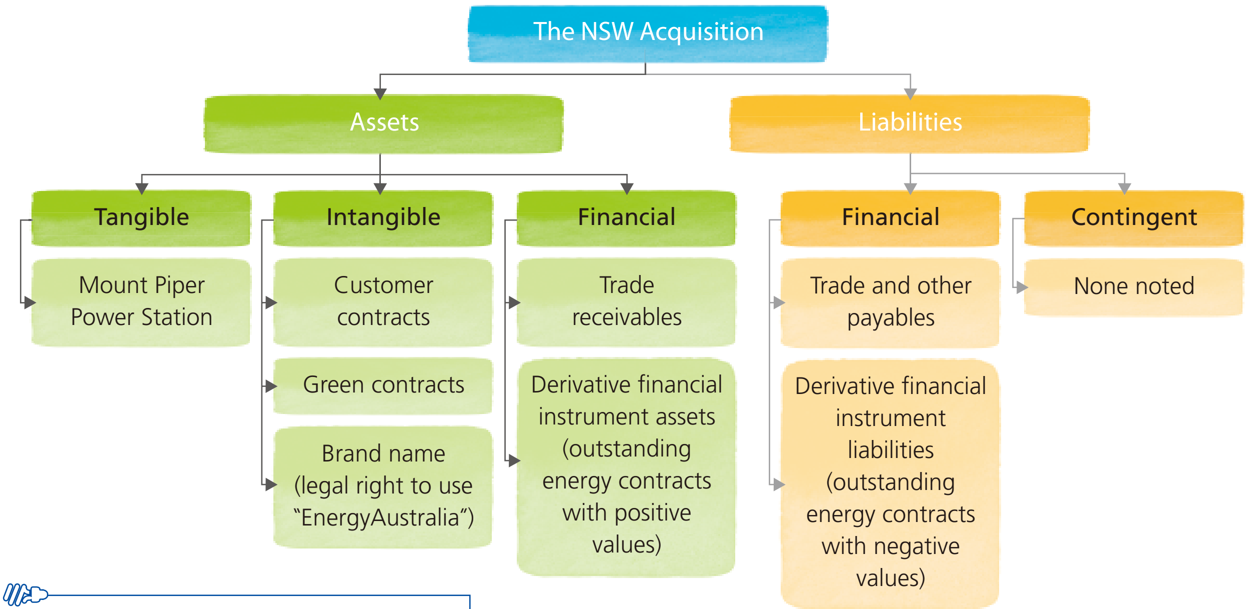
The process of the NSW Acquisition

Step 3: Recognise and measure identifiable assets and liabilities and non-controlling interests

Identifiable assets are classified into different kinds (i.e. tangible, intangible and financial) with different definitions in accounting. In relation to identifiable liabilities, last year's mini-series explained that contingent liabilities are only required to be disclosed in financial statements but not recorded on the balance sheet. However, in a business combination, any contingent liabilities associated with the subject business are required to be recorded as liabilities in the books of the acquirer. As a result, the assets and liabilities identified may include some items that have not been previously recognised by the subject business.

Assets acquired and liabilities assumed are recognised on the financial statements at their fair values on the acquisition date. Fair value means "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

Any non-controlling interest (NCI) in the subject business is measured at either (1) the non-controlling interest's proportionate share of identifiable net assets of the subject business, or (2) at its fair value. CLP has adopted the first option.

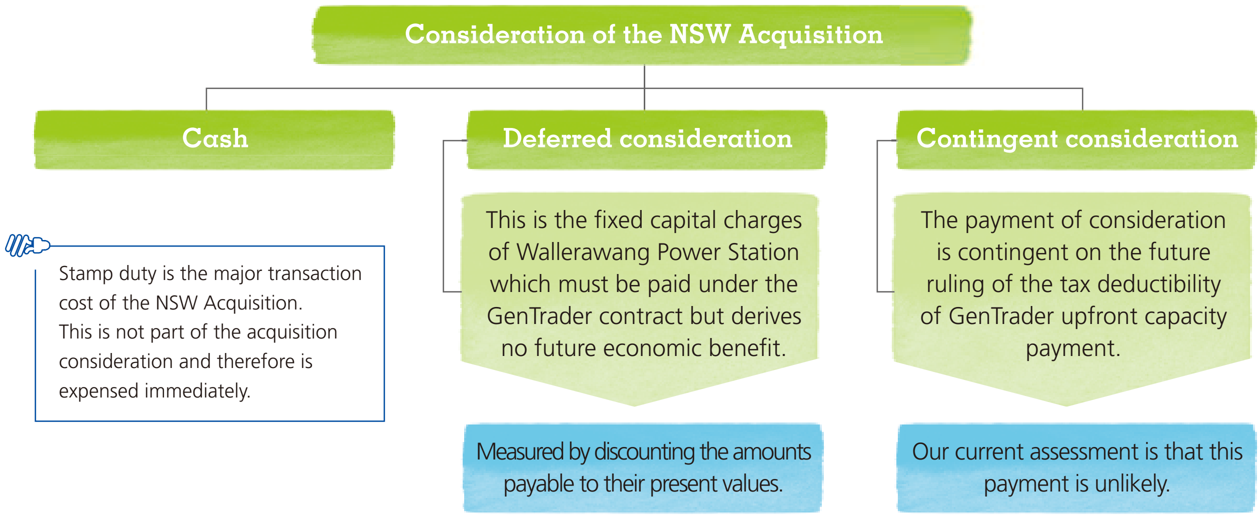


Professional assistance was sought to value some of the items whose fair values were not observable in the market.

Step 4: Recognise and measure the consideration transferred

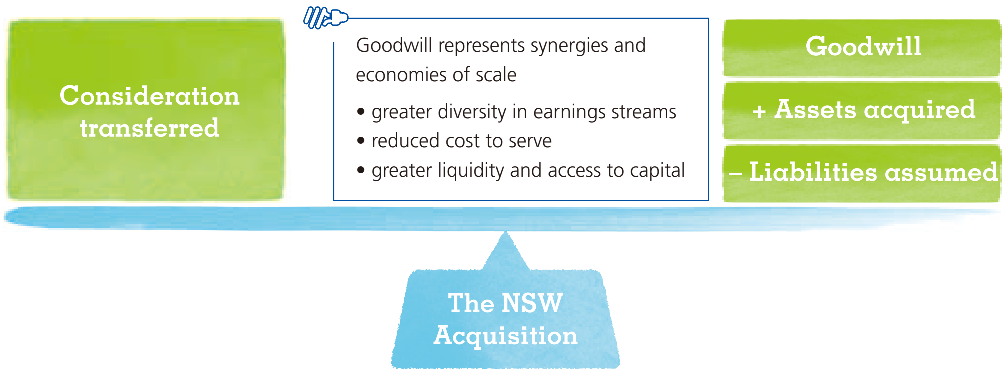
Acquisition consideration can be cash or cash equivalents and the fair value of any non-cash consideration given. The consideration may also be contingent or deferred. Contingent consideration is uncertain payments based on the occurrence of specified future events and is recognised at its fair value at the acquisition date. Deferred consideration is future payments with certainty which are discounted to reflect their present values at the acquisition date. The payments are discounted because payment at a future date is worth less than the payment of the same amount at the acquisition date.

Transaction costs or out-goings such as costs for the services of lawyers, investment bankers, accountants and valuation experts are always incurred in a business combination. People easily confuse these transaction costs with acquisition consideration. In fact, transaction costs have nothing to do with items acquired in a business combination and will not bring any future economic benefit. Therefore, they are charged as expenses at the time they are incurred.



Step 5: Recognise and measure goodwill or a gain from a bargain purchase

Goodwill represents the value created by the acquired business which does not relate to any physical attributes, and cannot be touched, seen or felt. It is measured as a residual, which represents the excess of (1) the consideration, (2) the amount of NCI, and (3) the acquirer's previously held interest at fair value over the fair value of the identifiable net assets acquired. In rare situations, such as a bargain purchase from a financially distressed seller, "negative" goodwill can arise and a gain will be recognised. Goodwill is recorded as an asset and is not written down over time. Instead, it is subject to annual impairment test or more frequently if there is an indication of impairment.



Planning for future transactions

The acquisition method results in the recognition of new assets and liabilities which were not previously recognised in the books of the subject business (e.g. customer relationships and contingent liabilities). Also, all the acquired items are required to be brought onto the acquirer's books at their fair values on the date of acquisition. The wider use of fair value increases both the number and complexity of valuations and adds to earnings volatility. In pursuing our growth strategy, CLP has to plan the approach for business acquisitions, anticipate the consequences of the transaction terms and assess potential outcomes for the financial statements.