PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS (Q&As)

<u>Q&A No. 2022-01</u>

Use of Going Concern Basis by an Absorbed Entity in a Merger Transaction (PAS 1, Presentation of Financial Statements)

Issue

For an entity that will be absorbed in a merger transaction, will the use of going concern basis in preparing its financial statements remain appropriate?

Background

1. Annual financial statements before the merger approval

- In January 20X1, the merger of Entity A and Entity B was approved by their respective Board of Directors (BOD) and Shareholders.

- In February 20X1, the Philippine Securities and Exchange Commission (SEC) approved the Articles and Plan of Merger.

- Upon effectivity of the merger, the following, among others, shall take effect in accordance with executed Articles and Plan of Merger:
    - Entity A and B shall become a single entity with Entity B as the surviving entity.
    - Entity A shall cease to exist, but its operations shall continue under Entity B.
    - Entity B, being the surviving entity, shall have rights to all assets of Entity A.
    - Entity B shall be responsible for all the liabilities and obligations of Entity A as though Entity B had itself incurred such liabilities or obligations and any pending claim, action or proceeding brought by or against Entity A. The rights of creditors or liens upon the property of Entity A shall not be impaired by the merger.

- In preparing its financial statements as of and for the year ended December 31, 20X0, is it appropriate for Entity A to use the going concern basis?

2. *Short-period financial statements before the merger approval*

- Assume the same fact pattern in (1.) above except that the merger of Entities A and B was approved by their respective BOD and Shareholders in July 20x1, and by the SEC in August 2021.
- In preparing a short-period financial statements as of and for the six (6) months ended June 30, 20X1, is it appropriate for Entity A to use the going concern basis?

Conclusion and Discussion

For Fact Patterns 1 and 2: Yes, the use of going concern basis of accounting remains appropriate.

When going concern assumption is not used, financial statements are prepared on a basis of accounting other than going concern (oftentimes referred to as liquidation basis of accounting). The key objective of liquidation basis financial statements is primarily to assist the users of those financial statements in their assessment of the amount of cash or other assets that they might reasonably expect to receive after the liquidation process is completed.

Liquidation is the process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

In the fact pattern described above, Entity A's existence will cease following the stipulations of the Articles and Plan of Merger but its operations shall continue under the merged/surviving entity (Entity B). The assets and liabilities of Entity A will not be liquidated but instead transferred to Entity B to continue the business. Accordingly, the financial statements of Entity A for the year ended December 31, 20X0 shall be prepared using the going concern basis.

Entity A shall disclose all the relevant information about the planned merger, including the fact that it shall cease to exist, but its operations shall continue under Entity B. For the short-period financial statements, it shall also comply with the disclosure on comparatives required under PAS 1.

Effective date

The effective date of the consensus in this Q&A is upon approval by the FRSC.

Date approved by PIC: February 16, 2022

PIC Members

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Date approved by FRSC: March 11, 2022

Accounting References

Philippine Accounting Standards (PAS) 1, Presentation of Financial Statements

- *Paragraph 25*
  When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.
- *Paragraph 36*
  An entity shall present a complete set of financial statements (including comparative information) at least annually. When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

  (a) the reason for using a longer or shorter period, and,
  (b) the fact that amounts presented in the financial statements are not entirely comparable.

Paragraph 14 of PAS 10, Events after Reporting Period
An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Paragraph 3.9 of The Conceptual Framework for Financial Reporting
Financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations: if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.