Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.ifrs.org)

11 August 2021

Dr Andreas Barckow
International Accounting Standards Board
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Canary Wharf
London E14 4HD
United Kingdom

Dear Andreas,

IASB Discussion Paper DP/2020/2
Business Combinations under Common Control

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants in Hong Kong. We are grateful for the opportunity to provide our comments and the comments of our stakeholders on this Discussion Paper (DP).

The HKICPA appreciates the IASB's initiatives in exploring possible reporting requirements for business combinations under common control (BCUCC). We agree that neither the acquisition method nor a book-value method should be applied to all BCUCC, and so we welcome the IASB in drawing a clear line for when each measurement method should be applied. We also welcome the IASB in specifying how a book-value method should be applied to reduce diversity in practice.

That said, the HKICPA has significant concerns about the IASB's preliminary view of prohibiting a receiving company from restating pre-combination information when applying a book-value method, for the following reasons, among others:

- Applying the IASB's preliminary view, the presentation of pre-combination information would solely depend on how the BCUCC is legally structured. This would result in different pre-combination information being presented for economically similar transactions, which would impair the comparability of financial statements. Also, we question how to apply the IASB's preliminary views to cases where it is economically unclear who the receiving company is, e.g. a merger of two equals.

- The IASB's preliminary view ignores the information needs of potential investors for BCUCC undertaken in preparation for an initial public offering (IPO). Potential investors need information that helps them assess the prospects for future cash flows of the listing group and management's stewardship of the listing group's economic resources. The HKICPA and its respondents consider that restating pre-combination information provides evidence of management's track record of the listing group as a whole, which meets the information needs of potential investors.

- For many years, Hong Kong listing applicants have been applying a book-value method to IPO cases and restating the pre-combination information in their IFRS/HKFRS financial statements to meet both the information needs of potential investors and the regulatory requirements in the Hong Kong Listing Rules. Such presentation is considered to be useful, effective and essential by investors for making investment decisions and by regulators for assessing the eligibility of the applicants for listing. Given that Hong Kong was the number one IPO venue globally in seven out of the past twelve years and was the second largest IPO market in the world in 2020[1], the IASB's preliminary view, if implemented, would inevitably create a significant negative impact to the investor community and the Hong Kong capital market.

Given the above, the HKICPA strongly recommends that the IASB provide an accounting policy choice for companies to choose whether to restate pre-combination information to cater for the information needs of potential investors and regulators.

In addition, the HKICPA has comments and recommendations on the following areas of the DP:

- Similar to non-controlling shareholders (NCS), not all related parties can always access the internal information of the receiving company. For example, investors with significant influence in associates often struggle to obtain internal financial information of the associates. In such cases, the information needs of related parties could be the same as the NCS of the receiving company. Accordingly, we recommend that the IASB remove the related party exception so the optional exemption would also apply to related parties.

- The IASB should further explore whether, and if so, how the information needs of holders of equity-like financial instruments that are not classified as equity under IAS 32 *Financial Instruments: Presentation* should be captured in this project given the prevalence of these instruments in private or pre-IPO companies. This may interact with the IASB's project *Financial Instruments with Characteristics of Equity (FICE)*, and so we recommend that the IASB consider this in the context of the FICE project.

- While we acknowledge the IASB's rationale of using the transferred company's book values to measure the assets and liabilities received when applying a book-value method, we consider that there are situations where using the controlling party's book values would better reflect the economic substance of the transaction and mitigate structuring opportunities. For example, this could be the case when the BCUCC is undertaken solely to hide goodwill and intangible assets related to the transferred company, and any associated impairment losses, arising from a past business combination. Accordingly, we recommend that the IASB provide an accounting policy option for companies to use the controlling party's book values when such an approach would provide useful information, and require companies to disclose which book values they have used.

Our detailed comments are provided in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me (ceciliakwei@hkicpa.org.hk), Carmen Ho (carmenho@hkicpa.org.hk) or Eky Liu (eky@hkicpa.org.hk), Associate Directors of the Standard Setting Department.

Sincerely,

Cecilia Kwei

Cecilia Kwei
Director, Standard Setting Department

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[1] https://www.hkex.com.hk/Join-Our-Market/IPO/Listing-with-HKEX?sc_lang=en

Work undertaken by HKICPA in forming its views

The HKICPA:

(i) issued an Invitation to Comment on DP/2020/2 on 8 December 2020 to its members and other stakeholders;
(ii) met with representatives from Hong Kong Exchanges and Clearing (HKEX), Hong Kong's listing regulatory body;
(iii) sought input from its Business Combinations and Reporting Entity Advisory Panel and Investment Circular Reporting Sub-Committee, which are mainly comprised of technical and industry experts from large as well as small and medium accounting firms (collectively, Practitioners);
(iv) held a public roundtable discussion on 11 May 2021, comprising investors, analysts, preparers, practitioners and regulators, with IASB Board member and staff participation; and
(v) developed its views through its Financial Reporting Standards Committee, having reflected on its stakeholder views. The Committee comprises academics, preparer representatives from various industry sectors, regulators, as well as technical and industry experts from small, medium and large accounting firms.

Detailed comments on IASB DP/2020/2

Selecting the measurement method (refer to DP Questions 2 and 3)

Overall

1. BCUCC are common in Hong Kong and occur for different reasons, such as group restructuring, tax planning, or preparing for an IPO. The HKICPA and its respondents consider that not all BUCCC have the same nature or economic substance; some are similar to business combinations covered by IFRS 3 *Business Combinations* while others are not. Therefore, we agree that neither the acquisition method nor a book-value method should be applied to all BCUCC, and welcome the IASB in drawing a clear line for when each measurement method should be applied.

2. However, our respondents expressed mixed views on the IASB's preliminary views on determining when to use which measurement approach based on whether the non-controlling shareholders (NCS) of the receiving company are affected by BCUCC:

   - Respondents who agreed with the IASB's preliminary views generally supported the idea that transactions that affect NCS of companies whose shares are publicly traded should be accounted for using the acquisition method because those BCUCC are normally conducted at an arm's length basis, and minority shareholders are often protected by local securities regulations. Also, listed companies usually have substantial NCS who are in a position to make voting decisions independently of the controlling shareholders. Therefore, these BCUCC are arguably similar to business combinations with a third party under IFRS 3.

   - Respondents who disagreed generally considered that:

     - The measurement method should not be based solely on the information needs of NCS. Information needs of other users, such as lenders, creditors, and potential investors should also be considered.

  - The measurement method should not be restricted by what is useful to the group of users from only the receiving company's perspective. Unlike business combinations under IFRS 3, BCUCC are often directed or influenced by the controlling party, hence the controlling party's information needs should also be considered.

  - The measurement method should not be driven by whether companies' shares are publicly listed or privately held because the substance of the transaction may not always be determinable or distinguishable based solely on listing status. Also, there are no existing IFRSs that determine the accounting of a transaction based on a company's listing status. Users would find it difficult to understand the change in measurement method for BCUCC once a company's status or shareholder composition changes. Moreover, under the IASB's preliminary views on the term 'receiving company' in paragraph 1.18 of the DP, the same transaction could be accounted for differently by the immediate receiving company and its parents in a multi-layered group if their listing statuses are different.

- Some respondents suggested that companies should be given a broad principle on which to apply their judgement to assess the nature and substance of a BCUCC, and apply accounting policies for similar transactions in a consistent manner as required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

3. The HKICPA acknowledges the respondents' concerns above. However, we think it would be highly subjective to determine the measurement method of a BCUCC based on solely the nature or substance as suggested by respondents. In particular, the terms 'nature' and 'substance' can be interpreted broadly, and different factors that influence the nature or substance of the transaction carry different weights in different circumstances. In addition, even if there is common understanding of these two terms, companies still need to apply significant judgement to determine the measurement method based on the specific facts and circumstances of each transaction. As a result, diversity in practice could still arise even under comparable fact patterns, and this would not provide useful information.

4. In addition, the HKICPA notes that although the respondents analyse BCUCC in different ways, they generally agreed with the overall conclusions that:

   - The acquisition method should be applied for BCUCC that affect NCS of the receiving company whose shares are publicly traded, because these BCUCC are more akin to business combinations under IFRS 3.

   - A book-value method could be applied to:

     - BCUCC for companies whose shares are privately held, as this takes into account cost-benefit considerations and addresses information needs of other financial statement users in addition to NCS; and

     - Internal group restructurings in IPO cases because these transactions do not have real commercial substance. This would allow companies to continue applying a book value method as per existing practice in Hong Kong.

5. The HKICPA agrees with the overall accounting outcomes resulting from the IASB's preliminary views. In the absence of other viable and objective suggestions of how a distinction could be made to determine the measurement method for BCUCC and

acknowledging that there is no perfect solution, we consider that the IASB's preliminary views is an objective, balanced and practical approach.

Related party exception

6. We and our respondents consider that similar to NCS, not all related parties can always access the internal financial information of the receiving company. We have heard from our stakeholders that sometimes investors with significant influence in associates often struggle to obtain internal financial information of the associates. In such cases, the information needs of related parties could be the same as the NCS of the receiving company. This situation is particularly common in Hong Kong and China given the persuasiveness of related party relationships among state-owned enterprises. Therefore, we recommend that the IASB remove the related party exception so the optional exemption would also apply to related parties.

Optional exemption

7. Our respondents expressed mixed views on the optional exemption from the acquisition method.

   - Some respondents considered that the optional exemption would work well in practice and did not raise any significant concerns.

   - Others considered that NCS may not always have the knowledge and competency to understand different types of measurement methods. Hence, these NCS may not understand the consequences of their decisions and whether or not they should object to the use of a book-value method.

   - Some also noted that because this optional exemption is applied on a transaction-by-transaction basis and driven by the decision of the NCS, different measurement methods could be applied in similar transactions. This would impair the comparability of financial statements.

   - A few respondents considered that the NCS opt-out mechanism should not be analogized to the consolidation exemption in paragraph 4(a)(i) of IFRS 10 *Consolidated Financial Statements* as they are used in different contexts. The consolidation exemption in IFRS 10 affects the presentation of financial statements, whereas the optional exemption affects the measurement method for a BCUCC.

8. We note that the objective of the optional exemption in the DP is so that the NCS can object to the company applying a book-value method and require the company to provide fair value information if they consider that is more useful to them. Hence, we think the optional exemption takes into consideration the information needs of NCS. It also takes into account the cost-benefit considerations of applying the acquisition method to privately held companies as discussed in paragraph 2.41 of the DP. In light of our respondents' concerns above, we recommend that the IASB further explore and understand whether there are practical challenges with implementing this proposal.

9. We and our respondents noted that in Hong Kong, private or pre-IPO companies are often funded by a variety of complex financial instruments, such as preference shares or convertible bonds. Depending on the terms of these instruments, they may not be classified as equity instruments under IAS 32 but may nevertheless have equity-like features. However, it seems that the DP does not address the information

needs of holders of these financial instruments. Therefore, we suggest that the IASB further explore whether, and if so, how these information needs should be captured; for example, whether they should be considered as NCS and what types of financial instruments should be considered. We think that this part of the project would interact with the IASB's project *Financial Instruments with Characteristics of Equity* (FICE), and so recommend that the IASB consider this in the context of the FICE project.

Applying a book-value method (refer to DP Questions 6 and 10)

Pre-combination information

10. We acknowledge that the IASB's preliminary view to require the receiving company to present only the pre-combination information of the receiving company (i.e. without restating pre-combination information) is consistent with the overall thought process of the DP that focuses on the perspective of the receiving company.

11. That said, we have significant concerns about the IASB's preliminary views for the following reasons:

    - Applying the IASB's preliminary views, the presentation of pre-combination information would solely depend on the legal structure of the transaction, i.e. which entity is the receiving company. This would result in different pre-combination information for economically similar transactions, which would reduce comparability. For example, Diagram 2.4 of the DP presents possible BCUCC in preparation for an initial public offering (IPO). Scenarios 2B, 2C and 2D of Diagram 2.4 would provide different pre-combination information following the IASB's preliminary views although the purpose of the BCUCC is the same – to list both company A and company B. Also, we question how to apply the IASB's preliminary views to cases where it is economically unclear which entity is the receiving company, for example, in a merger of two equals.

    - Unlike business combinations within the scope of IFRS 3, BCUCC undertaken for the purpose of IPO are often internal group restructurings. Restating pre-combination information in such cases would meet the information needs of potential investors because it provides evidence of management's track records of the listing group as a whole, which helps potential investors assess the prospects for future cash flows to the listing group and management's stewardship of the listing group's economic resources[2].

    - The HKEX Listing Rules require listing applicants to include an accountants' report in their prospectus. The accountants' report is prepared based on underlying IFRS/HKFRS financial statements and must provide historical financial information covering the preceding three financial years before listing.

      In Hong Kong, a group restructuring often takes place shortly before a listing, for example, setting a new parent company as the listing vehicle. Listing applicants normally apply a book-value method to account for such transactions and restate the pre-combination information in the primary financial statements to provide the three-year historical financial information. Such presentation has existed for many years, and is considered to be useful, effective and essential by investors for making investment decisions, and by regulators for assessing the eligibility of applicants for listing.

[2] Paragraph 1.3 of *Conceptual Framework for Financial Reporting*

Given that the HKEX was the fifth largest stock exchange in the world by market capitalization of listed companies as of June 2021[3], and Hong Kong has been the number one IPO venue globally in seven out of the past twelve years and was the second largest IPO market in the world in 2020[1], the IASB's preliminary view, if implemented, would inevitably create a significant negative impact to the investor community and the Hong Kong capital market.

If the IASB were to prohibit the presentation of restated pre-combination information in the financial statements, this would necessarily result in other parties such as capital market regulators setting relevant requirements, e.g. to have such information presented as pro forma information in IPO prospectuses. We believe this would impair the quality and completeness of information presented under IFRS because under such an approach, useful information for investors and other users to make informed economic decisions would only be presented outside IFRS financial statements. Also, were regulators to require restated pre-combination information to be presented as pro forma information in IPO prospectuses, they would also likely require such information to be audited, which would not be optimal from a cost and efficiency perspective.

- A concept similar to pro-forma financial information has already existed in the accounting for reverse acquisitions in IFRS 3, where the consolidated financial statements of the legal acquirer, including comparative information, represent the continuation of the financial statements of the legal subsidiary except for its capital structure. We do not consider that presenting the pre-combination information of the combined company on an 'as if' basis would introduce a new concept to IFRS.

- The issue of pre-combination information is only a presentation matter. It does not affect the recognition and measurement of the combined entity at the combination date or subsequently. Therefore, the IASB should not prohibit companies from restating pre-combination information when companies are willing to do so to meet their users' information needs.

12. We acknowledge that in certain situations, for example for private companies that are not preparing for IPO, the costs of restating pre-combination information would not justify the benefits, or that users of financial statements may not need such pre-combination information. In those cases, we agree that companies should not be required to restate the pre-combination information, but this does not necessitate that there be a general prohibition on restatement.

13. In light of the above, we strongly recommend that the IASB provide an accounting policy choice to allow companies to choose whether to restate pre-combination information to cater for the information needs and practice of different users and jurisdictions.

Measuring assets and liabilities received

14. The HKICPA acknowledges that the IASB's preliminary views on requiring the receiving company to use the transferred company's book values to measure assets and liabilities received are in line with the overall thinking of the DP that focuses on the receiving company's perspective.

[3] https://www.sfc.hk/-/media/EN/files/SOM/MarketStatistics/a01.pdf

15. However, some respondents expressed concerns about the IASB's preliminary views and considered that:

- Applying the IASB's preliminary views, a book-value method would be applied to BCUCC that do not affect the NCS of the receiving company, or where the NCS do not object the use of a book-value method. Under such circumstances, the controlling parties would be the primary users and it is more logical to measure assets and liabilities received from the controlling parties' perspective.

- Using the transferred company's book values may create structuring opportunities for the receiving company to hide any goodwill and intangible assets, and potentially any associated impairment losses, related to the transferred company. Consider a scenario where the controlling party acquired several transferred companies from external parties and in doing so recognised goodwill and intangible assets in its consolidated financial statements. Subsequently, the controlling party set up a new investment holding company (Interco) and directed Interco to acquire the transferred companies. Applying the IASB's preliminary views, Interco would be able to 'reset' the book values of the transferred companies without having to recognise the goodwill and intangible assets. Respondents considered that in this case, the consolidated financial statements of Interco (i.e. the receiving company) represent a continuation of the financial statements of the controlling party, and so, the controlling party's book values should be used.

- For cases where a listed company spins off part of its businesses to another group company (often a newly set-up company, 'NewCo'), the financial information of the spun-off group presented in the listed company's financial statements (as a discontinued operation) would be different from that included in the NewCo's first set of financial statements, and this may confuse users.

- Practical challenges would arise if the transferred company does not prepare IFRS financial statements.

- The IASB could set up a rebuttable presumption that a receiving company can use the ultimate controlling party's book value. Book values at other levels (e.g. immediate or intermediate parent) could also be used based on the specific facts and circumstances to meet users' needs. The receiving company should be required to disclose who the controlling party is and which book values are used.

16. We note that the IASB's preliminary views are inconsistent with the principles of merger accounting in the HKICPA's Accounting Guideline 5 (AG 5) *Merger Accounting for Common Control Combinations*[4], which requires companies to use the book values from the controlling parties' perspective.

[4] Accounting Guidelines have effect as guidance statements and indicators of best practice. They are not mandatory but persuasive in intent.
https://www.hkicpa.org.hk/-/media/HKICPA-Website/Members-Handbook/volumeII/ag5_re20.pdf

17. Findings from our post-implementation review of AG 5[5] informed us that there are practical challenges when using the controlling parties' book values, e.g. who the controlling party in a multi-layered group is and what carrying values should be used if the controlling parties are individuals or do not prepare IFRS financial statements. Nevertheless, we anticipate that there could be similar challenges when using the transferred company's book values.

18. Overall, while we acknowledge the IASB's rationale of using the transferred company's book values, we consider that there are situations where using the controlling party's book values would better reflect the economic substance of the transaction and mitigate structuring opportunities as stated in paragraph 15 above. Accordingly, we recommend that the IASB provide an accounting policy option for companies to use the controlling party's book values when such an approach would provide more relevant and useful information, and require companies to disclose which book values they have used.

~ End ~

[5] https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section6_standards/standards/FinancialReporting/comment-letters/2016/msag5/AG5Feedback.pdf