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

Meeting with Business Combinations and Reporting Entity Advisory Panel
(via video-conference)

Date: 24 February 2021

Time: 10:00 am – 12:15 pm

IASB Discussion Paper on Business Combinations under Common Control (DP)

- Panel members noted that the objective of the meeting was to seek feedback from the Panel on the DP.
- SSD staff provided an overview of the DP and a summary of the initial feedback from local stakeholders received from previous outreach activities.

1. Scope of the DP

- A Panel member had the following comments:
  - This member noted that in describing BCUCC, IFRS 3 requires that common control is ‘not transitory; but the term ‘transitory control’ is not clearly explained in IFRS 3 or in the DP. This member suggested that the IASB clarifies whether ‘transitory control’ should be taken into account when considering transactions within the scope of the project and if so, provides a clear definition.
  - This Panel member noted that the scope of the DP includes a transfer of a business that may not meet the definition of a business combination, e.g. company P sets up a new company, Newco, and transfers the control of its subsidiary, company A to Newco. This Panel member considered that the substance of these transactions may be different from other BCUCC that meet the definition of a business combination under IFRS 3, and is more similar to a continuation of the transferred company. Therefore, this panel member suggested that the IASB considers more comprehensively the measurement method for transactions involving Newco and how each measurement method should be applied for such transactions, in particular,
    a) whether the substance of transactions involving Newco is the same as that of the other BCUCC and therefore the decision tree in diagram 2.5 of the DP is also applicable to such transactions;
    b) whether the Newco or the transferred company is the reporting entity. If the Newco is the reporting entity, no comparative information would be provided about the transferred company; if the transferred company is the reporting entity, then comparative information would be provided about the transferred company.

    This Panel member noted that transactions involving Newco are common among real estate investment trusts and private companies preparing for IPO in Hong Kong.
- Two Panel members supported the IASB’s preliminary views on including transactions

involving Newco within the scope of the DP because such transactions are common in Hong Kong, and application issues exist. Also, some stakeholders find the existing guidance in paragraph 5 of AG 5 on similar types of transactions is hard to understand and implement in practice.

- A Panel member suggested that the IASB should also consider the accounting for the transfer of associates between companies that are under common control.

2. When to apply which measurement method

General comments

- A Panel member considered that the IASB's preliminary views, which requires companies whose shares are publicly-traded to apply the acquisition method, are appropriate.
- A Panel member was not convinced by the IASB's preliminary views and its rationale on when to apply which measurement method. He considered that by applying the IASB's preliminary views, a private company would need to change its accounting for BCUCC after it becomes listed. He was concerned that this would constitute a change in accounting policy under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This Panel member considered that a company should apply the same accounting policy consistently for BCUCC throughout the life cycle of the company and should not change its accounting policy solely because it becomes listed. This Panel member did not disagree with applying the acquisition method to BCUCC undertaken by listed companies, but that a company should also apply the same method to BCUCC before it becomes listed.
- Another Panel member was also not convinced by the IASB's preliminary views on when to apply which measurement method for the following reasons:
  - This Panel member considered that BCUCC are different from business combinations with unrelated third parties.
  - The factors on how to determine the measurement method in the DP (listed vs private; any objection by non-controlling shareholders (NCS)) are similar to the criteria for the consolidation exemption under IFRS 10 *Consolidated Financial Statements*. This Panel member was not convinced that the same criteria should be applied to determining the measurement method for BCUCC.
  - This Panel member considered that there is merit in using a book-value method for BCUCC as it reflects the combination of two companies that are under common control.
- A Panel member did not support the IASB's preliminary views that the accounting for BCUCC would depend on whether the transaction affects NCS of the receiving company. Specifically, for IPO cases, the controlling party already holds substantial interest in the operating companies. This Panel member did not see whether, and if so how, the existence of NCS would affect the measurement method in such cases. He considered that the IABS's

preliminary views on using NCS as the determinable factor might result in incomparable information about BCUCC.

- Another Panel member expressed the following views:
  - The accounting for business combinations under IFRS 3 requires an acquirer to measure the assets and liabilities received at fair value and this resets the book value of the acquiree to fair value. BCUCC is a sub-set of business combinations but is scoped-out from IFRS 3 for many reasons, for example, not to recognise internally generated intangible assets and reset the book value to fair value for related party transactions.
  - Not all BCUCC are of similar nature or have the same substance. The nature of BCUCC undertaken by listed companies are different from those undertaken by private companies. The nature of BCUCC undertaken by listed companies is arguably similar to those business combinations with unrelated third parties because the Hong Kong Listing Rules ensure transactions undertaken by listed companies are conducted at an arm's length basis and that the minority shareholders are protected[1]. Accordingly, in a BUCCC, listed companies are acting as if they were transacting with unrelated third parties. In addition, listed companies are substantive entities on their own with business independent from the controlling party. Therefore, applying the acquisition method to BCUCC undertaken by listed companies would be appropriate as recognising goodwill and fair value measurement would help promote stewardship, which are important for listed companies. In contrast, for BCUCC that are undertaken by private companies or for the purpose of IPO, the nature of those transactions is arguably different from that of business combinations with unrelated third parties. Applying the acquisition method to those BCUCC may also pose challenges because it may be difficult to identify the acquirer and to prove that the consideration is a fair price.
  - Paragraph 13 of IAS 8 requires an entity to select and apply its accounting policies consistently for similar transactions. Applying this requirement to BCUCC, companies should apply the same accounting to BCUCC that are of similar nature. Therefore, it would be reasonable that a company apply a different accounting method to BCUCC after it becomes listed because the nature of the BCUCC changes.
  - Practical challenges exist in the application of merger accounting in AG 5. Companies applying AG 5 are required to restate the comparatives, and this poses practical challenges to preparers and auditors of private companies. On the other hand, applying the acquisition method would also pose practical challenges to private companies because other than the costs incurred for fair value measurement, measuring the

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[1] Rule 14.58(8) of the Main Board Listing Rules requires the directors of the listed entity to state in the announcement that the terms of the transaction are fair and reasonable and in the interests of the shareholders as a whole.

acquired assets and liabilities received at fair value might confuse management as they are the primary users of the financial statements and they do not need fair value information.

  - If a book-value method is applied to BCUCC undertaken by listed companies, the listed companies would be required to restate the comparatives under AG 5 (including the 5-year financial information summary in the annual report[2]). This Panel member questioned whether, for BCUCC that are similar to business combinations with unrelated third parties, existing shareholders of a listed company would need restated financial information. He considered that the restated comparatives would distort the trend analysis of financial performance of the listed company.
  - For companies undertaking BCUCC for the purpose of IPO, a book-value method that requires restatement of comparatives could provide a track record of financial information of the listing companies for users of financial statements for analysis and investment decision-making.
- Another Panel member expressed the following views:
  - Applying the IASB's preliminary views, a company would change the accounting for BCUCC in the following situations:
    a) a private company would apply a different accounting method to BCUCC after it becomes listed.
    b) a wholly-owned private company would apply a different accounting method for BCUCC after it becomes a partially-owned subsidiary.

    This Panel member considered that the IASB should clarify whether such change would constitute a change in accounting policy under IAS 8.
  - In IPO cases, some companies entered into certain financing arrangements where the companies' ordinary shareholders would be entitled to certain redemption rights (e.g. such shares could be redeemed if IPO is not successful). Because of the redemption rights, these shares are classified as liabilities under IAS 32 *Financial Instruments: Presentation*. This Panel member would like to clarify whether holders of these instruments would be classified as NCS under the DP.
  - In relation to the related-party exception, this Panel member questioned whether the presumption that related parties could have access to the internal information of the receiving company would always be valid. In practice, similar to NCS, some related parties also do not have internal information of the company. This Panel member

[2] Rule 19 of Appendix 16 of the Main Board Listing Rules requires a listed issuer shall include a summary, in the form of a comparative table, of the published results and of the assets and liabilities of the group for the last five financial years. Where the published results and statement of assets and liabilities have not been prepared on a consistent basis this must be explained in the summary.

suggested that the IASB removes the related-party exception so that all NCS (no matter whether they are related parties or not) would be allowed to determine the measurement method for BCUCC under the optional exemption.

- Another Panel member noted that one reason to scope out BCUCC from IFRS 3 is to avoid remeasuring the assets and liabilities to fair value as a result of group restructuring – to minimize structuring opportunities. However, this Panel member agreed that not all related parties could have access to the internal information of the receiving company and some may behave like unrelated NCS.
- A Panel member considered that instead of requiring the receiving company to apply a book-value method to BCUCC that do not affect NCS of the receiving company, the IASB should also allow the receiving company to choose the measurement method (the acquisition method or a book-value method) for BCUCC in such cases. This Panel member noted that some private companies would like to reflect the fair value of their listing businesses in the financial statements before they go for IPO.
- Another Panel member noted that there are practical difficulties for wholly-owned private companies to apply the acquisition method to BCUCC, namely identifying the acquirer and whether there is evidence that the consideration is a fair price.

3. How to apply a book-value method

a) Pre-combination information

- A Panel member was concerned about the IASB's preliminary views on prohibiting the restatement of comparatives because there would be problems for IPO applicants (which are usually newly incorporated companies) to present the 3-year historical financial information of the listing business in accordance with the requirements under the Hong Kong Listing Rules. Considering that companies in China are required to restate the comparatives under the CASBE, this Panel member suggested that the Institute works jointly with the Accounting Regulatory Department of the Ministry of Finance in China in recommending the IASB to reconsider its preliminary views in this area.
- A Panel member also expressed concerns on the IASB's preliminary views on prohibiting the restatement of comparatives for the following reasons:
    - Other than the potential issues for IPO applicants to comply with the Hong Kong Listing Rules to present the 3-year historical financial information, there would be no comparatives in the first set of annual financial statements after the company (which is a newly incorporated listing vehicle) becomes listed. This Panel member considered that the IASB should consider whether users, in particular potential investors, would require the historical financial information for their analysis and investment decision-making for IPO cases.

  - This Panel member acknowledged that there could be practical challenges in restating the comparatives in certain situations. However, this Panel member noted that some companies were not concerned about the practical difficulties and costs incurred in restating the comparatives, and that restating comparatives would not cause differences in the financial statements for later reporting periods. Therefore, this Panel member suggested that the IASB considers providing an accounting policy choice for companies to choose whether they would like to restate the comparatives in order to meet their users' needs.
- Another Panel member supported providing an accounting policy choice for companies to choose whether they would like to restate the comparatives to cater for users' needs.
- A Panel member was also concerned about the potential impact of the IASB's preliminary views on the ability of the IPO applicants to comply with the Hong Kong Listing Rules to present 3-year historical financial information. This Panel member noted that the IASB's preliminary views are not consistent with the existing guidance in AG 5. In addition to IPO applicants, he also considered that there could be potential impact on listed companies to comply with the Hong Kong Listing Rules to present the 3-year historical financial information in the accountant's reports[3] if the target companies undergo BCUCC, in particular, listed companies have a practice of setting up a new shell company to facilitate the acquisition of a target business from their parent just before acquisition date.
- A Panel member was less concerned about the potential impact of the IASB's preliminary views on the ability of IPO applicants to present the 3-year historical financial information. This Panel member considered that IASB issues IFRS for general purpose financial statements. However, IPO applicants prepare special purpose financial statements for the purpose of IPO. In his experience, there were cases where special purpose financial statements departed from IFRS, e.g. where the financial statements presented are combined financial statements or carve-out financial statements, and where the IPO applicant disclosed in the basis of preparation that the financial statements departed from IFRS 10 *Consolidated Financial Statements*. Following the same logic, this Panel member considered that IPO applicants could still restate their comparatives even if the IASB were to go ahead with its proposals because they could state in the basis of preparation that the

[3] Rule 14.67(6) of the Main Board Listing Rules states that a circular issued in relation to an acquisition constituting a major acquisition must contain an accountants' report prepared in accordance with Chapter 4 of the Listing Rules. This requirement also applies to a very substantial acquisition circular or listing document issued for a reverse takeover under Rule 14.69. Rule 4.06 requires that concerning a circular in connection with a reverse takeover, a very substantial acquisition or a major transaction on the acquisition of a business or a company, the accountants' report must include the three-year track record of the business or companies to be acquired.

financial statements are prepared in accordance with IFRS except for the presentation of comparatives.

- Three Panel members considered that if the IASB were to go ahead with its preliminary views, IPO applicants would not be able to state in the basis of preparation that the special purpose financial statements (for the purpose of IPO) and their first set of annual financial statements (after the company becomes listed) are prepared in accordance with IFRS/HKFRS. Currently, IFRS is silent on the accounting for BCUCC and AG 5 is local guidance, so companies can choose their own accounting policies for BCUCC. However, once the IASB issues a standard for BCUCC, restating comparatives would be inconsistent with the requirements in IFRS. These Panel members also considered that preparation of combined financial statements is not a departure from IFRS/HKFRS because the *Conceptual Framework for Financial Reporting* defines combined financial statements and explicitly mentions the considerations for combined financial statements when determining the reporting entity.
- A Panel member considered that it would be appropriate for private companies to apply the prospective approach having considered the cost-benefits considerations.

b) Measuring the assets and liabilities received

- A Panel member expressed the following views:
  - In her experience, there are not many concerns about using the book values from the perspective of the controlling party to measure the assets and liabilities received under AG 5.
  - Applying the IASB's preliminary views to cases where a listed company spins off part of its business for the purpose of IPO, the financial information of the spin-off business as stated in its original parent's consolidated financial statements (as a discontinued operation) and those in its financial statements (for the purpose of IPO) would be different, and this would confuse users of financial statements.
  - Applying the IASB's preliminary views, practical challenges would exist if the transferred company does not prepare financial statements in accordance with IFRS.
  - Companies recognise goodwill and identifiable intangible assets of the acquired companies upon acquisition from unrelated third parties applying IFRS 3. If these acquired companies were transferred to a group company in a BCUCC, then all the goodwill and identifiable intangible assets recognised in the consolidated financial statements of their immediate parent/controlling party would not be included in the receiving company's financial statements applying the IASB's preliminary views. This may result in what some might consider an understatement of assets or even a negative net book value in the financial statement of the receiving company, especially for the financial service industry.

- Another Panel member asked about the accounting treatment of the transferred company's off-balance sheet items (e.g. contingent liabilities) under the IASB's preliminary views on how to apply a book-value method.
- A Panel member did not have significant concern on the IASB's preliminary views on how to measure the assets and liabilities received.
- A member asked whether, under paragraph 5 of AG 5, a Newco should measure the assets and liabilities received at the transferred company's book value or at the book value from the controlling party's perspective.
- A Panel member expressed the following comments:
  - Paragraph 5 of AG 5 addresses a specific fact pattern of transaction involving a Newco (i.e. inserting a shell entity between a parent entity and a single subsidiary or between a parent entity and a group of subsidiaries), and AG 5 suggests that such transaction may be accounted for by applying a principle similar to that for a reverse acquisition. The consolidated financial statements of the Newco represent the continuation of the financial statements of the single subsidiary or the group of subsidiaries. Therefore, the Newco would measure the assets and liabilities received at the transferred company's book values.
  - This Panel member noted that there are other types of transactions involving Newco which are more complex than that in paragraph 5 of AG 5, and in those scenarios, more factors should be considered when determining how to measure the assets and liabilities received. Factors may include:
    - a) Is the transaction similar to a reverse acquisition?
    - b) Does the transaction involve any third party shareholders?
    - c) Does the Newco have its own subsidiary before the transfer?
    - d) Does the Newco act as an acquisition vehicle for other company?
  - This Panel member also noted that for the purpose of IPO in Hong Kong, red-chip companies normally set up Newco as listing vehicles and transfer the listing businesses/companies (which are usually a subgroup) to the Newco. Such a transaction usually does not have substance as its main purpose is to re-domicile the immediate holding company of the subgroup to another jurisdiction. Therefore, the consolidated financial statements of the Newco represent a continuation of the transferred subgroup and the Newco measures the assets and liabilities received at the subgroup's book values from the perspective of its previous immediate holding company (not from the ultimate controlling party's perspective).
  - This Panel member noted that although the IASB's preliminary views on how to measure assets and liabilities received seems to be consistent with existing accounting practice for transactions involving Newco, it would be useful if the IASB sets out the requirements in IFRS so as to enhance consistent application. In addition, this Panel

member suggested that the IASB considers the accounting for more complicated scenarios that involve Newco.

- A Panel member noted that in addition to IPO cases, transactions involving Newco also occur in private group restructurings in Hong Kong. Private companies that are wholly–owned by another body corporate are not required to prepare consolidated financial statements under the Hong Kong Companies Ordinance (s379(3)(a)). To be eligible for the exemption from preparing consolidated financial statements, some private companies that are held by individuals set up a shell company (which is incorporated in other jurisdictions) and transfer the operating group to the shell company so that it can fulfill the relevant requirements under the Hong Kong Companies Ordinance.
- A Panel member agreed that for transactions involving the transfer of a single subsidiary to a Newco, the Newco measures the assets and liabilities received using the transferred company's book value. If the transfer involves a group of subsidiaries, then more consideration should be taken into account when determining how to measure the assets and liabilities received, e.g. whether the transfer involves business segments that are part of a subgroup.
- A Panel member shared the following specific fact pattern:
  - Company P holds three wholly-owned subsidiaries directly, S1, S2 and S3. Each of these subsidiaries were acquired from third parties and each has its own business.
  - P forms a new company (Newco) as the listing vehicle and transfers S1 and S2 to the Newco for the purpose of IPO.

  This Panel member considered that the setting up of Newco is to effect the combination of S1 and S2, and hence this is a business combination under common control under AG 5. In this case, the Newco should measure S1 and S2 using the book value of S1 and S2 from the perspective of Company P according to AG 5.

c) *Measuring the consideration paid*

- A Panel member shared the following views:
  - There is diversity in practice in how the receiving companies measure consideration that are own shares. This Panel member understood the IASB's rationale of not prescribing measurement method for share consideration. However, she considered that there could be financial impact to the receiving company's separate financial statements, in particular in the case of share consideration, whether the receiving company should measure its investment in subsidiaries at the fair value of the shares, the nominal value of the shares or with reference to the net book value of the receiving company.
  - In cases where the consideration paid are in assets, the current market practice is to measure the consideration at the fair value of the assets given up following the principles in the *Conceptual Framework for Financial Reporting*.

- Another Panel member also considered that the IASB should provide guidance on how to measure the consideration that are own shares for the following reasons:
    - There is diversity in practice in how the receiving companies measure the consideration paid in their own shares.
    - The accounting treatment for share consideration would impact the amount recognised in different equity components (e.g. share premium) in the financial statements of the receiving company. This would affect the receiving company's distributable reserve.

4. How to apply the acquisition method

- A Panel member agreed with the IASB's preliminary views and its rationale on:
    - Requiring the receiving company to recognise a contribution in case of a 'bargain purchase'; and
    - Not requiring the receiving company to identify, measure and recognise a distribution.

  This Panel member noted that the Hong Kong Listing Rules require listed companies to conduct transactions in a fair and reasonable manner and in the interests of the shareholders as a whole[1]. Hence, this Panel member considered that contributions and distributions would be unlikely to occur in practice for listed companies. It would also be difficult for users of financial statements to identify from the financial statements and investment circulars whether there is any contribution/distribution unless more information about the transactions is provided.