Meeting with Investment Circular Reporting Sub-Committee

(via video-conference)

Date: 4 February 2021, Thursday

Time: 2:00 pm – 4:15pm

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

- Sub-Committee members noted that the objective of the meeting was to seek feedback from the Sub-Committee 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 member generally agreed with the scope of the project as set out in the DP. This member noted that the scope of the project covers all transfers of businesses in which all of the combining companies are ultimately controlled by the same party. He considered that it would be helpful if the IASB clarifies the accounting for transactions that involve combinations of group companies together with acquisition of a company from a third party at the same time.
- Another member noted that transactions involving inserting a shell entity between a parent entity and a single subsidiary or between a parent entity and a group of subsidiaries is not a business combination as defined in IFRS 3 *Business Combinations*. This member considered that such transactions usually do not have economic substance and that the consolidated financial statements of the shell entity usually represent the continuation of the financial statements of the parent entity.

2. When to apply which measurement method

a) General comments

- A member expressed the following views:
  - The IASB's preliminary views on when to apply which measurement method focuses on the perspective of the receiving company, which seems to be driven largely by the legal form of the receiving company and how the combination is structured. This member considered that paragraphs 3.10 to 3.14 of the *Conceptual Framework for Financial Reporting* does not restrict the boundary of a reporting entity by its legal form.
  - The IASB's preliminary views seems to presume that the acquisition method is always the best and appropriate method to account for BCUCC and the book-value method is only a 'practical expedient'. This member considered that the IASB should, instead,

consider which method(s) would provide the most relevant and useful information about BCUCC under different scenarios.

- Having said that, this member considered that the IASB's preliminary views would generally work well for most BCUCC undertaken by listed companies. However, this member encountered a transaction that was a merger of equals (merger of two Stated-owned Enterprises). As only one company survived after the combination, it would be difficult to identify the receiving company applying the IASB's preliminary views. This member considered that the accounting from the perspective of the controlling party (i.e. the government) would be appropriate in such case but acknowledged that mergers of equals are not common in Hong Kong.

- Another member did not have significant concerns for listed companies to apply the acquisition method to BCUCC.
- Two members noted that a majority of IPO cases in Hong Kong involve setting up a new shell entity as the listing vehicle. This enables the controlling shareholder to separate its listing business from other parts of its non-listing business. These members considered that the setting up of a new shell entity is a transitional arrangement for IPO, and therefore such transaction has no substance. In addition, the non-controlling shareholders (NCS) of the new shell entity would not be the sole primary users of financial statements. The primary users should also include the prospective investors. The information needs of the prospective investors should also be considered when determining the measurement method for IPO cases.
- A member noted that for IPO cases, it is common in the biotechnology industry that there are preferred shareholders and holders of convertible bonds before a group restructuring, and these instruments may be classified as liabilities under IAS 32 *Financial Instruments.* This member questioned whether holders of these financial instruments would be considered as NCS in the DP and whether their information needs should be considered.
- A member noted that from his experience, preferred shareholders usually come in after group restructuring is completed for the purpose of IPO. It is uncommon that each of the combining entities has its own preferred shareholders that are then combined together.
- A member did not support the IASB's preliminary views on when to apply which measurement method for the following reasons:
  - This member considered that similar transactions should be accounted for in the same way while different transactions should be accounted for differently. Therefore, the measurement method for BCUCC should not depend on whether the company is listed or not, or whether the receiving company has NCS or not.
  - Users of financial statements would find it difficult to understand the different types of measurement methods and the rationale for the change in the measurement method once the company becomes listed or the composition of its shareholdings changes. For

example, there could be a situation where there are different measurement methods for BCUCC undertaken by a receiving company in the same year if the company that is originally a wholly-owned subsidiary becomes a partially-owned subsidiary.

This member would prefer to apply consistent accounting policies for similar transactions under paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

- Another member also considered that a company should apply consistent accounting policies for similar transactions.

b) Related party exception

- A member considered that there is no conceptual basis to require the receiving company to apply a book-value method if all of its NCS are related parties. This member also considered that it is sometimes difficult to identify the related party relationships in Hong Kong and China given the definition of related parties in IAS 24 *Related Party Disclosures* covers a wide range of parties.
- Another member also found it difficult to understand the conceptual rationale for the related party exception and identify related party relationships in practice. He shared that businesses in Hong Kong are usually started by couples or relatives. When the company is planning to go for an IPO, pre-IPO investors and preference shareholders will come in. This member questioned why a book value method would be required when all preference shareholders or pre-IPO investors are related parties instead of providing them with an option to select the measurement approach.

c) Optional exemption

- A member questioned whether the optional exemption could work in practice because the NCS may not have the relevant accounting knowledge on different types of measurement methods and hence would not be able to decide whether they would object the use of a book-value method.
- Another member considered that this optional exemption would work in practice. There is similar mechanism under the Hong Kong Listing Rules which requires approval by independent shareholders for connected transactions.

d) Extending the exemption and exception to companies whose shares are publicly-traded

- A member considered that the suggestion of extending the exemption and exception to listed companies is not relevant to Hong Kong as it is unlikely that all the NCS of a listed company are its related parties under the Hong Kong Listing Rules.

3. How to apply a book-value method

a) Pre-combination information

- A member strongly disagreed with the IASB's preliminary views on how to provide pre-combination information for the following reasons:
  - This member considered that a prohibition of restatement of comparatives would be a problem for IPO cases in Hong Kong. In particular, considering that a majority of the IPO cases in Hong Kong involve setting up a new shell company as the listing vehicle to facilitate the combinations of several operating entities for IPO purpose. The listing vehicle is usually set up just before it goes for a listing. Therefore, there would be a problem for IPO applicants to comply with the Hong Kong Listing Rules on presenting the three-year historical financial information and the profit test requirements[1] if the listing vehicle can only present its historical financial information applying the IASB's preliminary views (which is usually less than 3 years).
  - The IASB's preliminary view focuses narrowly on determining who the receiving company is (which is driven by its legal form), and ignores the boundary of the reporting entity. In this Panel member's view, for IPO cases, the reporting entity's financial statements should reflect the historical financial information about the underlying listing businesses, not only the receiving company. Accordingly, he considered that a top-down approach or a carve-out concept (i.e. to present the financial statements of the combined entity from the perspective of the controlling party) would be more appropriate for IPO cases.
- Two members also agreed that the IASB's preliminary views on pre-combination information do not fit for IPO cases in Hong Kong. These Panel members considered that for IPO cases, the primary users of the financial statements are prospective investors and they need historical financial information of the listing businesses that is prepared on a consistent basis to perform trend analysis of the financial performance of the listing businesses. These Panel members suggested that the IASB should allow entities to restate the comparatives for IPO cases.
- Two members did not object applying the IASB's preliminary views for private entities that are not preparing for IPO because they considered that in those cases, the purpose of the combinations is not to seek prospective investors to invest in the combined company as in IPO cases. Hence, determining the boundary of the reporting entity would normally follow its legal form, and therefore the reporting entity would usually be the receiving company.

---

1 Rule 4.04 of the Main Board Listing Rules requires a new listing applicant to include in tis accountants' report its consolidated results in respect of each of the three financial years preceding the issue of the listing document. Rule 8.05 of the Main Board Listing Rules requires an IPO applicant to satisfy either the profit test in rule 8.05(1) or the market capitalization/revenue/cash flow test in rule 8.05(2) or the market capitalization/revenue test in rule 8.05(3). In respect of the profit test, the IPO applicant must have a three-year trading record during which the profit attributable to shareholders must, in respect of the most recent year, be not less than HK$20 million and, in respect of the two preceding year, be in aggregate not less than HK$30 million.

- A member considered that whether an IPO applicant could comply with the three-year historical financial information and profit test requirements under the Hong Kong Listing Rules depend on how its financial statements are prepared in accordance with HKFRS/IFRS. Therefore, he considered that if the IASB were to go ahead with its proposals on pre-combination information, the Hong Kong Stock Exchange might need to consider amending the Hong Kong Listing Rules on the three-year historical financial information and the profit test requirements, or providing guidance on how IPO applicants could comply with those requirements.
- Another member noted that currently, the Hong Kong Stock Exchange accepts, in certain circumstances, presenting the three-year historical financial information of the listing businesses using more than one accountants' report. For example, if there is a change in the controlling shareholder during the third year of the track record period, then the first set of accountants' report would cover the historical financial information of the listing businesses for the first and second year of the track record period and the second set of accountants' report would cover the historical financial information of the listing businesses for the third year of the track record period. Therefore, in this Panel member's view, it might not be necessary for the Hong Kong Stock Exchange to amend the relevant Listing Rules if the IASB were to go ahead with its preliminary views on pre-combination information. However, this member considered that presenting the three-year historical financial information of the listing businesses over a number of accountants' reports would not be useful for prospective investors as this would not provide a full picture of the historical financial information of the listing businesses.

b) Measuring the assets and liabilities received

- A member considered that the concept of a book-value method is to present the combined entity's financial statements from the perspective of the controlling party. The combined entity is a component in the controlling party's consolidated financial statements. Under this concept, it would be more logical for the reporting entity to recognise the assets and liabilities received using the carrying amounts in the controlling party's consolidated financial statements.

4. How to apply the acquisition method

- Two members did not have significant concerns on the IASB's preliminary views on how to apply the acquisition method to BCUCC. In particular, a member considered that there would be practical difficulties to quantify the amount of overpayment as a distribution from the receiving company because this would require measurement of the fair value of the transferred entity and synergies expected from the combination. This member also considered that it would be unlikely for listed companies in Hong Kong to recognise contributions/distributions because listed companies need to explain to its NCS why the BCUCC is not conducted at arm's length.