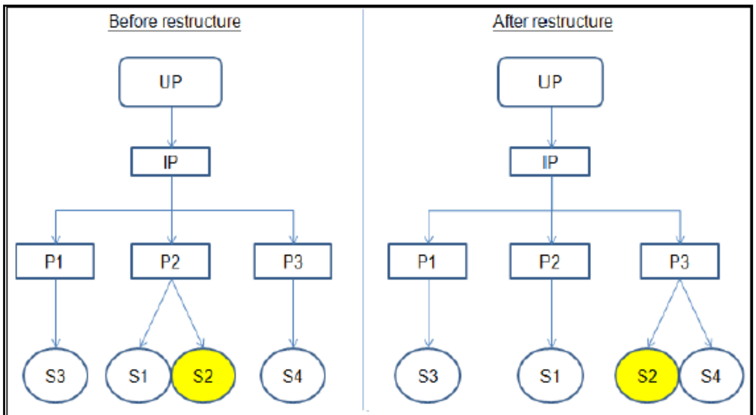
Meeting Summary
HKICPA-HKSFA Roundtable with Investors: Group Restructures

Date: 18 November 2016
Venue: Offices of Hong Kong Society of Financial Analyst (HKSFA)
Participants:
Andy Chan, Central Net Investment
Carmen Tse, FTI Consulting
Cedric Wong, HKSFA
Donald Fung, Malayan Bank
Frederick Tsang, China Everbright
Ke Wu, FMC Corporation
Patrick Ip, China-ASEAN Capital Advisory
Peter Chow, Sinomart KTS Development
Thomas Lau, United Gain Fund
Yash Agarwal, UBS Investment Bank

1. HKICPA staff presented an overview of the accounting for group restructures (also known as combinations under common control) in Hong Kong and the current status of developing a global accounting standard for such transactions. The staff also introduced the purpose of its outreach with investors and HKICPA's research on group restructures. The meeting discussion covers the following scenarios:
   (a) A private group of companies restructured by selling a business from one subsidiary P2 to another subsidiary P3. After the restructure, subsidiary B goes IPO.

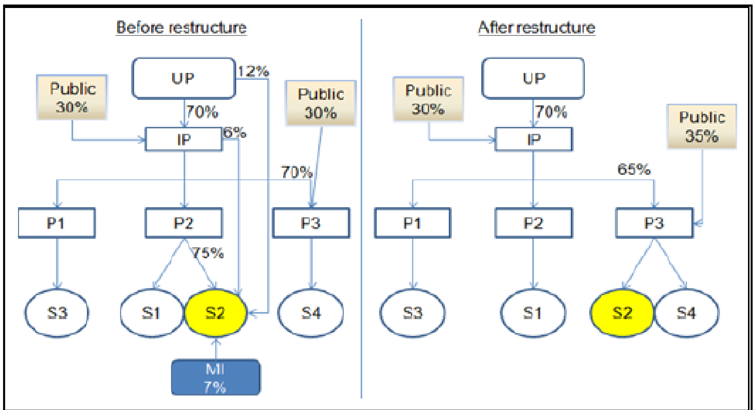


Background of group before restructure
- IP/P2 acquired S2 from a third party. After a few years, UP acquired IP/P2.
- Acquisition accounting under HKFRS 3 was applied for the two separate transactions by IP/P2 and UP. This resulted in different carrying amounts of S2 in the consolidated financial statements of both IP/P2 and UP.

Background of restructure
- S2 was transferred from P2 to P3.
- It was determined that the transfer of S2 constitutes a common control combination. Merger accounting was applied in the consolidated financial statements of P3.

[Illustration 2]

(b) A group of companies restructured by selling a business from one private subsidiary P2 (100% held by a listed parent company IP) to a listed subsidiary P3 (70% owned by the same listed parent company IP). The purpose of the restructure is to maximise synergies.



<u>Background of group before restructure</u>

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<u>Background of restructure</u>

- UP, IP and P2 transfer their shares in S2 to P3. P3 issued 5% of its shares to MI in return for 7% shares in S2. Accordingly, P3 obtains 100% shareholding in S2 after restructure.
- The restructure was undertaken to maximize the synergies between P3, S2 and S4.
- It was determined that the transfer of S2 constitutes a common control combination. Merger accounting was applied in the consolidated financial statements of P3.

[Illustration 3]

2. Investor participants were interested to know the reasons for group restructures for the purpose of IPO in Hong Kong.

Method of accounting for group restructures – general discussion

3. HKICPA staff explained the principles, objectives and differences in accounting under the acquisition method per HKFRS 3 *Business Combinations* and the merger method per HKICPA's Accounting Guideline 5 *Merger Accounting for Common Control Transactions*.
4. A banking participant considers the acquisition method would typically better reflect an acquired business (including those that are acquired from a related party). The participant thinks the fair valuation of the acquired business and the recognition of goodwill or bargain purchase would enable investors to better appreciate the economics of the newly combined group.
5. The participant is aware that some investors are concerned about applying the acquisition method on related-party acquisitions due to potential artificial uplift in the fair values. However, the participant believes that knowing the current value of a newly acquired business is more useful than the carry-forward book values, which may reflect an outdated value of the business.
6. Another participant commented that it might be more useful to apply AG 5 (merger method) for related party acquisitions if the business that is sold/acquired is integral to the core business of the overall group. This is, to maintain a comparable value among all entities within the group.

7. Another participant questioned whether it is appropriate to recognise goodwill or a bargain purchase from related party acquisitions if the acquisition method is applied. This is because the consideration may not be at market price.
8. Overall, a majority of participants thinks that each of the methods has advantages and disadvantages. If possible, the participants would prefer that there just be one method of accounting for acquisitions between related parties. Alternatively, the accounting standard should have sound and objective principles or guidance on which method is more appropriate to apply—thus minimising the flexibility provided to preparers.
9. In addition, participants believe that if the acquisition method is also applied to related party acquisitions, the concern regarding the reliability of the fair valuation performed should be addressed. Some participants are aware that, in practice, two or more companies with similar facts and circumstances can report vastly different fair valuation numbers. These participants observe that this may be due to whether the company adopts an aggressive or conservative strategy.

Group restructures for the purpose of IPO

10. The meeting discussed Illustration 2. In particular, participants were asked:
    (a) Who in Illustration 2 would investors consider the controlling party; and
    (b) Is it useful to know who is the controlling party.
11. Participants expressed mixed views about who, from an investor's perspective, would more appropriately be the controlling party. Some participants consider that the ultimate parent entity/individual is almost always the controlling party, being the head of the group. Some participants are of the view that the immediate parent entity (especially those in a multi-structured group) has the highest stakes in the target business, so the immediate parent is the controlling party.
12. Participants think that, based on the current AG 5 principles, preparers can decide who is the controlling party based on which entity would provide the best S3 carrying values to suit the targeted outcome of the acquiring company. They therefore think that preparers should explain in the financial statements, who is the controlling party and why. They also requested that there should be more objective principles in AG 5 for making this decision.
13. Referring to Illustration 2, participants also observed that:
    (a) P3 could have the incentive to pay less for acquiring S2 (and therefore apply the merger method if carry forward book values is lower than performing a fair valuation) so that P3 earns a higher profit if S2 is subsequently sold after the IPO.
    (b) P3 could also have the incentive to apply the acquisition method to take advantage of a potential artificial uplift in fair values, therefore enabling P3 to list at a higher IPO price.
14. The participants reiterated the importance for having sound and objective principles for when it is appropriate to use the acquisition method and the merger method.

Group restructures involving listed companies

15. The meeting discussed Illustration 3. In particular, participants were asked what information they would like to see in the financial statements post-restructure if they were a minority shareholder of listed company IP, P2 or listed company P3.
16. Participants think that there is no significant change in economic substance from the perspective of an IP investor.
17. From a P3 minority shareholder perspective, some participants think that it would be appropriate to recognise the assets and liabilities of S2 based on the valuation provided to shareholders if the price paid for S2 reflects the market valuation of S2 and all shareholders approve the price paid for the related party acquisition. Other participants observe that in practice, disclosure of S2's fair values are sufficient for some minority shareholders. Nevertheless, they acknowledge that disclosing the fair valuation numbers may not be sufficient for other minority shareholders as they may not comprehend the difference between information disclosed and the values recognised in the financial statements.
18. Some participants observe that, from P3's perspective, acquiring S2 from P2 may be similar to an acquisition from outside of the group. Therefore, the accounting outcome should be the same. In fact, these participants are aware that some companies would ensure that an acquisition with a related party would be comparable to acquiring a company externally and that the consideration paid would be at market price.
19. Overall, all participants consider that if the acquisition method is applied, companies should be required to disclose the key assumptions behind the fair valuation of the related party acquisition. The key assumptions should at least include projected forecast cash flows or major plans resulting from the acquisition, the discount rate, the valuation method/approach applied and sensitivity analyses. Some participants also requested that companies should be required to disclose details of the valuation expert because, in some jurisdictions, the expert can be related parties of the acquiring company.
20. Participants also requested that anti-abuse mechanisms be factored in the accounting to reduce the opportunity for preparers to manipulate the outcome/results arising from an acquisition.

Other comments

21. One participant would like information on how the group restructure impacts the operating cash flows of IP, P2 and P3 as that would indicate that there is a 'real' change in economic substance. If no cash is involved, the acquisition would just represent a non-cash transaction and the accounting/information provided would not matter as much.
22. All participants commented that understanding the form of consideration, and how the consideration was determined, matters. This is because it helps them understand whether the related party acquisition was 'fair', that is, at market price and at arms-length.