SSAP 27
STATEMENT OF STANDARD ACCOUNTING PRACTICE 27
ACCOUNTING FOR GROUP RECONSTRUCTIONS

(Issued March 2000 and revised June 2001 in red text and underlined type)

*The standards, which have been set in **bold italic type,** should be read in the context of the background material and implementation guidance and in the context of the Foreword to Statements of Standard Accounting Practice, Interpretations and Accounting Guidelines. Statements of Standard Accounting Practice are not intended to apply to immaterial items (see paragraph 8 of the Foreword).*

Introduction

The objective of this Statement is to prescribe principles for the accounting treatment and disclosure of group reconstructions.

The Companies (Amendment) Ordinance 1999 introduces the concept of merger relief and thus, for Hong Kong incorporated companies, removes the legal obstacle to merger accounting. In general, it relieves companies from the basic requirement to set up a share premium account either in respect of equity shares issued in exchange for shares in another company in the course of a transaction which results in the issuing company securing at least a 90% holding in the equity shares of the other company, or in respect of shares (equity or non-equity) issued by a wholly-owned subsidiary to its holding company or to another wholly-owned subsidiary of the holding company in consideration for the transfer of non-cash assets. Similar merger relief provisions may also be available in other jurisdictions which the preparers of financial statements would need to consider.

Two different methods have been developed to account for business combinations: acquisition accounting and merger accounting. In general, under acquisition accounting, the results of the acquiree are brought into the consolidated accounts only from the date of acquisition. In merger accounting, the financial statements are aggregated and presented as if the combining companies had always been together. Accordingly, although the combination may have taken place part of the way through the year, the use of merger accounting results in the full year's results of both combining enterprises being reflected in the consolidated accounts for the year and corresponding amounts are presented on the same basis.

Even though the merger relief provisions of the Companies Ordinance referred to above facilitate merger accounting, they have very little to do with accounting per se. This Statement establishes the circumstances when merger accounting should be used in a group reconstruction and the principles to be applied in such circumstances.

The fact that a particular group reconstruction does not fall within the specific circumstances qualifying for the use of merger accounting as set out in this Statement, and is thus accounted for by using acquisition accounting, does not preclude the acquirer from obtaining merger relief in its individual parent company financial statements under the provisions in sections 48C and 48D of the Companies Ordinance if the requirements of those sections are met. In such cases, in the consolidated accounts, acquisition accounting is applied in the normal way: goodwill is calculated by comparing the fair value of the shares issued, rather than their nominal or recorded value, taken together with the fair value of any other consideration, with the fair value of net identifiable assets acquired; and any excess of the fair value of the shares issued over their nominal value is shown, not as a share premium account, but as a separate reserve.

Scope

1. ***This Statement should be applied in accounting and reporting for business combinations resulting from transactions among enterprises under common control ("group reconstructions").***

2. This Statement only deals with the forms of accounting used in consolidated financial statements.

Definitions

3. ***The following terms are used in the Statement with the meanings specified :***

A business combination is the bringing together of separate enterprises into one economic entity as a result of one enterprise uniting with or obtaining control over the net assets and operations of another enterprise.

A group reconstruction is a business combination resulting from transactions among enterprises under common control.

An acquisition is a business combination in which one of the enterprises, the acquirer, obtains control over the net assets and operations of another enterprise, the acquiree, in exchange for the transfer of assets, incurrence of a liability or issue of equity.

Control is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

Merger relief is, ~~as a result of a share-for-share exchange:~~

a. ***relief from a requirement, whether under the Hong Kong Companies Ordinance or under the applicable law of the country of incorporation, to record a premium in a non-distributable share premium account; or***

b. ***the ability to record a premium in a share premium account that is distributable.***

4. Group reconstructions may include the following arrangements where there has been a transfer of control:

   a. the transfer of a shareholding in a subsidiary from one group company to another;

   b. the addition of a new parent company to a group;

   c. the transfer of shares in one or more subsidiaries of a group to a new company that is not a group company but whose shareholders are the same as those of the group's parent;

   d. the combination into a group of two or more companies that before the combination had the same shareholders.

Use of merger accounting

5. ***A group reconstruction should be accounted for by using merger accounting if :***

a. ***merger relief is taken advantage of;***

b. ***the ultimate shareholders remain the same, and the rights of each such shareholder, relative to the others, are unchanged; and***

c. ***any minority interest in the net assets of the group is unaltered by the transfer.***

Acquisition accounting should be used for all group reconstructions that are not accounted for by using merger accounting.

6. Merger accounting is appropriate for a group reconstruction, provided that the relative rights of the ultimate shareholders are not altered. Such reconstructions include not only the transfer of shares in a subsidiary within a group, but also arrangements such as the introduction of a new holding company, the splitting off of one or more subsidiaries, as in some demergers, where a separate group is formed, and the bringing together into a new group of two or more companies that were previously under common ownership. Acquisition accounting would require the restatement at fair value of the assets and liabilities of the company transferred, and the recognition of goodwill, which is likely to be inappropriate in the case of a transaction that does not alter the relative rights of the ultimate shareholders.

7. Where a minority interest exists, merger accounting is permitted only for those group reconstructions that do not change the interest of the minority in the net assets of the group. Thus the transfer of a subsidiary within a subgroup that has a minority shareholder may qualify for merger accounting; but acquisition accounting must be used for the transfer of a subsidiary out of, or into, such a subgroup. If a minority has effectively acquired, or disposed of, rights to part of the net assets of the group, this Statement requires the transfer to be accounted for by using acquisition accounting rather than merger accounting.

Merger accounting

8. In applying merger accounting, the financial statement items of the combining enterprises for the period in which the combination occurs and for any comparative periods disclosed should be included in the financial statements of the combined enterprises as if they had been combined from the beginning of the earliest period presented. The financial statements of an enterprise should not incorporate a combination to which the enterprise is a party if the date of the combination is after the date of the most recent balance sheet included in the financial statements.

9. Any difference between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount recorded for the share capital acquired should be included in equity as a separate reserve ~~and should not be included in the statement of recognised gains and losses.~~

10. The concept underlying the use of merger accounting to account for a group reconstruction is that no acquisition has occurred and there has been a continuation of the risks and benefits to the ultimate shareholders that existed prior to the group reconstruction. Use of merger accounting recognises this by accounting for the combined enterprises as though the separate businesses were continuing as before. Accordingly, only minimal changes are made in aggregating the individual financial statements.

11. When a group reconstruction results in a single combined entity, a single uniform set of accounting policies is adopted by that entity. Therefore, the combined entity recognises the assets, liabilities and equity of the combining enterprises at their existing carrying amounts adjusted only as a result of conforming with the combining enterprises' accounting policies and applying those policies to all periods presented. There is no recognition of any new goodwill or negative goodwill. Similarly, the effects of all transactions between the combining enterprises, whether occurring before or after the combination, are eliminated in preparing the financial statements of the combined entity.

12. Expenditures incurred in relation to a group reconstruction that is to be accounted for by using merger accounting should be recognised as expenses in the period in which they are incurred.

13. Expenditures incurred in relation to a group reconstruction that is to be accounted for by using merger accounting include professional fees, registration fees, costs of furnishing information to shareholders and salaries and other expenses related to services of employees involved in achieving the group reconstruction. They also include any costs or losses incurred in combining operations of the previously separate businesses.

Acquisition accounting

14. ***Group reconstructions not accounted for by merger accounting should be accounted for by acquisition accounting.***

15. Under acquisition accounting, the identifiable assets and liabilities of the companies acquired are included in the acquirer's consolidated balance sheet at their fair value at the date of acquisition. The results and cash flows of the acquiree are brought into the consolidated accounts only from the date of acquisition. The corresponding amounts for the previous period for the reporting entity are not adjusted. The difference between the fair value of the net identifiable assets acquired and the fair value of the purchase consideration is goodwill, positive or negative.

16. The fact that a particular group reconstruction does not fall within the specific circumstances qualifying for the use of merger accounting as set out in this Statement, and is thus accounted for by using acquisition accounting, does not preclude the acquirer from obtaining merger relief in its individual parent company financial statements under the provisions in sections 48C and 48D of the Companies Ordinance if the requirements of those sections are met. In such cases, in the consolidated accounts, acquisition accounting is applied in the normal way: goodwill is calculated by comparing the fair value of the shares issued, rather than their nominal or recorded value, taken together with the fair value of any other consideration, with the fair value of net identifiable assets acquired; and any excess of the fair value of the shares issued over their nominal value is shown, not as a share premium account, but as a separate reserve.

Disclosure

17. ***Enterprises applying this Statement in accounting for a group reconstruction using merger accounting should disclose in their consolidated financial statements the fact that merger accounting has been used.***

18. ***Bearing in mind the necessity of showing a true and fair view, enterprises applying this Statement should disclose in their consolidated financial statements significant details of the group reconstruction in so far as they affect the shareholders of the parent company.***

19. ***Group reconstructions accounted for using acquisition accounting should disclose the information required under ~~SSAP 7 "Group accounts"~~ SSAP 30 "Business combinations" and SSAP 32 "Consolidated financial statements and accounting for investments in subsidiaries", if applicable.***

Effective date

20. ***Except for the revised definition of merger relief in paragraph 3, the ~~The~~ accounting practices set out in this Statement should be regarded as standard~~s~~ in respect of transactions entered into on or after 11 November 1999. The revised definition of merger relief should be regarded as standard in respect of transactions entered into on or after 19 June 2001. Earlier adoption is encouraged.***

Notes on legal requirements

Group accounts

21. The legal requirements in Hong Kong with regard to the form and content of group accounts and other matters relating to subsidiaries of a company are dealt with in SSAP 32 "Consolidated financial statements and accounting for investments in subsidiaries". ~~SSAP 7 "Group accounts". However, the Companies (Amendment) Ordinance 1999 contains certain amendments to section 126 of the Companies Ordinance with regard to the contents of group accounts. In particular, it is no longer possible to override the requirement that if the financial year of a subsidiary is not co-terminous with that of the holding company, the group accounts should deal with the subsidiary's results and state of affairs as of the last financial year ending on or before the date of the holding company's balance sheet. Furthemore, group accounts must now state the reasons why the financial year of a subsidiary does not coincide with that of the holding company.~~

Share premium and merger relief

22. Section 48B(1) of the Companies Ordinance provides that if a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares should be transferred to an account called the share premium account. The provisions of the Companies Ordinance relating to the reduction of a company's share capital apply, with exceptions, as if the share premium account were part of its paid-up share capital.

23. Limited relief from the above ("merger relief") is given by sections 48C to 48F of the Companies Ordinance.

24. Section 48C of the Companies Ordinance provides, inter alia, that, subject to specified conditions, where an issuing company has secured at least a 90 per cent equity holding in another company, section 48B does not apply to the premium on shares issued in the transaction which takes the holding in that other company to at least 90 per cent.

25. Section 48D of the Companies Ordinance provides that where a wholly-owned subsidiary issues shares to its holding company or to another wholly-owned subsidiary of the holding company for assets other than cash, being assets of any company which is a member of the group of companies which comprises the holding company and any wholly-owned subsidiary of the holding company, the minimum amount required to be transferred to the share premium account under section 48B shall be based on the lower of the book value and original cost to the transferor company of those assets (less the book value of liabilities assumed).

26. Section 48E provides that the premium on any shares to which the relief in sections 48C and 48D of the Companies Ordinance applies may also be disregarded in determining the amount at which any shares, or other consideration provided for the shares issued, is to be included in the offeror company's balance sheet.

Compliance with International Accounting Standards

27. International Accounting Standard (IAS) 22 "Business combinations" excludes from its scope combinations between enterprises under common control. However, the description of merger accounting in this Statement is consistent with the pooling of interests method as referred to in IAS 22.