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

Organismo Italiano di Contabilità

Business Combinations under Common Control

Summary of Joint Investor Survey

ASAF MEETING, JULY 2018
AGENDA PAPER 5

Introduction

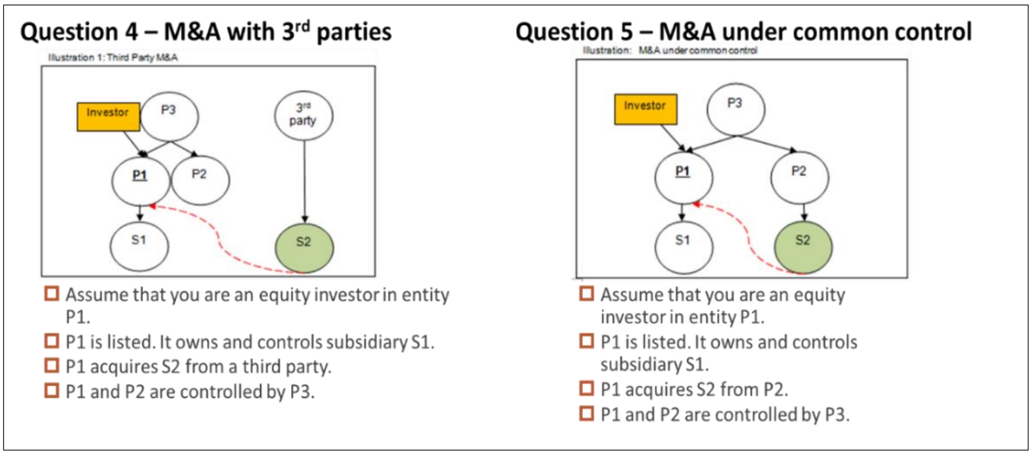
1. Mergers and acquisitions (M&As) are common and can take the form of 'group restructuring' or third party acquisitions. There is normally no question that there is underlying substance to M&As with third parties, but M&As within a group under common control might arguably be different.

2. This led the staff of the HKICPA Standard Setting Department and the Organismo Italiano di Contabilità (OIC) to jointly conduct an online investor survey from August 2017 to February 2018.

3. The survey aimed at:
   - understanding whether investors consider the underlying substance of M&As under common control and M&As with third parties differently; and
   - exploring the factors that could indicate the differences in the underlying substance of M&As under common control and M&As with third parties.

4. We hoped that the findings of the survey could help us consider whether all M&As should be accounted for in the same way (if the underlying substance is the same) and would provide input to the IASB's project on Business Combinations under Common Control.

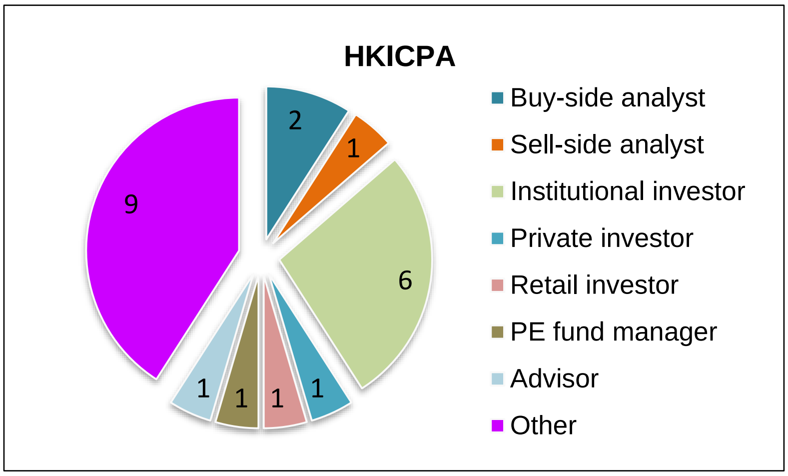
5. The survey contained five questions:
   - The first two questions requested the background of the respondents.
   - Question 3 asked whether respondents consider the substance of an M&A under common control is always different from that of an M&A with third parties. Those who responded 'no' were not required to answer Questions 4 and 5. Other responses were 'yes' and 'maybe'.
   - Question 4 included an illustration of an M&A with a third party and Question 5 included an illustration of an M&A under common control (refer to next page for the illustrations). Both questions asked to identify factors that are important in evaluating the substance of these M&As using a scale of 1 to 10 (where 1 is not important and 10 is very important). The list of factors is reproduced in Appendix A of this paper.

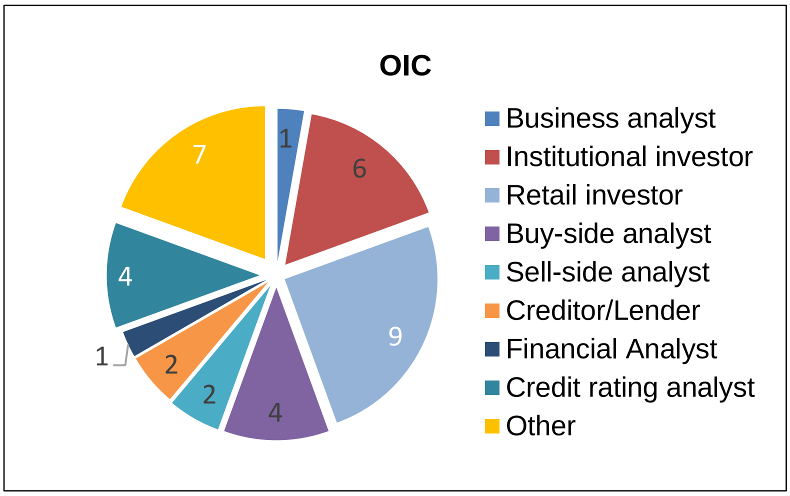


Background of the respondents

6. About half of total respondents were institutional investors and retail investors. Other respondents included analysts in various capacities. These respondents were either based in Asia or Europe.

Based in	HKICPA	OIC
Asia	19	1
Europe	3	35
Total responses	22	36

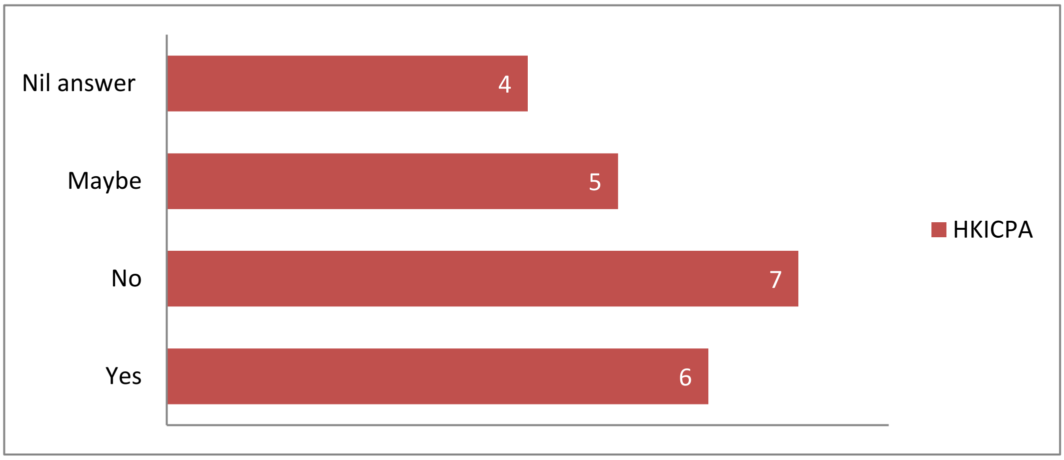




Findings and Analysis – HKICPA respondents

7. Respondents expressed mixed views as to whether the substance of M&As under common control is always different from M&As with third parties. Mainly institutional investors, sell-side analysts and buy-side analysts responded 'yes' or 'maybe'; which indicates that they generally perceive the substance of M&As under common control may be different from M&As with third parties. Those responded 'no' did not disclose their background.

8. The chart below summarises the responses to Question 3 collected by HKICPA.



9. The following tables summarise the responses to Questions 4 and 5. As a reminder, only respondents who did not answer Question 3 or think that the substance of M&As under common control is always or may be different from the substance of M&As with third parties answered Questions 4 and 5. The tables outline the top factors out of seventeen total factors that respondents considered important in evaluating the underlying substance of M&As with third parties and M&As under common control. Factors highlighted in grey are the top most important factors that are common in both situations. The last factor(s) of each table is(are) added to show factor(s) that is(are) considered less important in M&As with third parties but not M&As under common control, and vice versa.

M&As with third parties

Rank	Factor	Average rating
1	The M&A is expected to bring material changes to P1's future cashflow.	8.8
2	Consideration is at fair market value of S2.	8.2
3	The M&A is expected to turn P1 from loss-making to profit-making.	7.3
4	Consideration consists purely of issuance of shares in P1.	7.3
5	Consideration consists purely of cash.	7.1
15	Underlying business purpose of the acquisition is to achieve tax benefits for entity P3.	5.2

M&As under common control

Rank	Factor	Average rating
1	Consideration consists purely of issuance of shares in P1.	7.8
2	Consideration is at fair market value of S2.	7.5
3	The M&A is expected to bring material changes to P1's future cashflow.	6.9
4	The M&A is expected to turn P1 from loss-making to profit-making.	6.8
5	Consideration is a mix of cash and P1's shares.	6.8
7	Underlying business purpose of the acquisition is to achieve tax benefits for entity P3.	6.7
12	Consideration consists purely of cash.	6.2

10. We found that 70% of respondents picked the same top three factors as important when determining the substance of the transactions in both Questions 4 and 5. Those top three factors were, whether:

- The M&A is expected to bring material changes to the acquirer's future cashflow.
- The M&A is expected to turn the acquirer from loss-making to profit-making.
- Consideration is at fair market value of the acquired businesses/entities.

11. This indicates that respondents who initially thought that M&As under common control have or may have a different substance from M&As with third parties apply the same factors to evaluate the underlying substance of the transactions. Accordingly, HKICPA staff think that when these three factors are present in an M&A under common control, investors are likely to conclude that the M&A under common control has similar or the same substance as an M&A with third parties.

12. We interviewed some investors who responded to our survey about this finding. These investors believe that there is a perception that M&As under common control have a different substance to M&As with third parties – clearly this may not be true in reality. These investors also commented that the example in Question 5 illustrates an acquisition within a simple group structure. In reality, at least in Hong Kong, it is common for internal acquisitions to take place in large conglomerates with multi-layered parent companies.

13. From the survey results, HKICPA staff think that the top common factors indicate that the expected synergistic effects of an M&A and a fair exchange are strong determinants of the substance of an M&A.

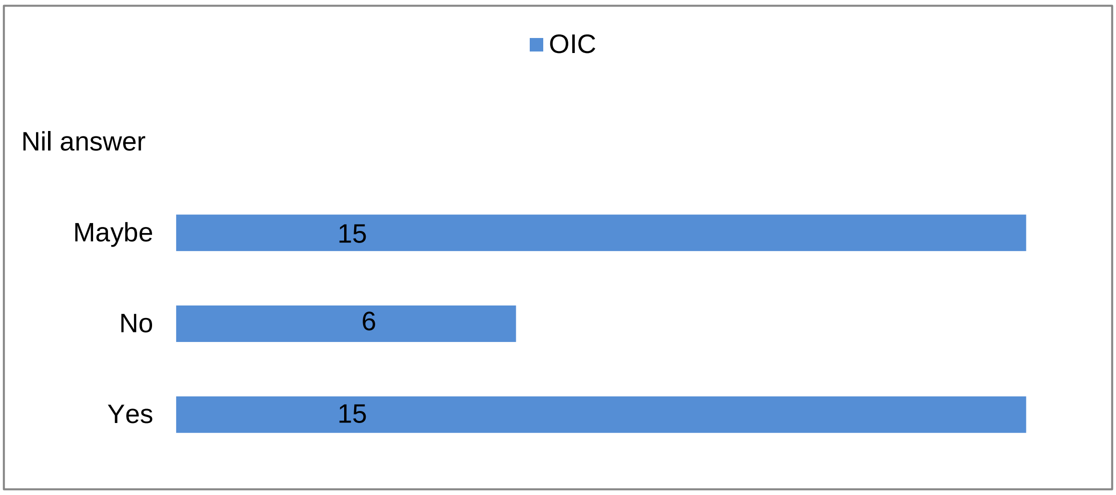
14. Interesting to note is investors from Asia rated the form of consideration (i.e. whether paid in cash, shares or a combination that reflects the fair market value of the acquired businesses) as important when considering the underlying substance in both M&As under common

control and with third parties. This may reflect the unique situation in Asia whereby M&As in this region can be settled in many ways that are not necessarily cash.

15. We also noted that investors did not believe consideration in the form of pure cash is a very important factor for determining substance underlying M&As under common control. This could reflect that M&As under common control that are not settled 100% in cash does not represent a lack of substance. This is perhaps because, when compared to businesses under common control that are transferred at nil or nominal consideration or at an amount to be settled in the future—all of which are also commonly seen in Asia—an M&A that reflects a fair exchange is a stronger factor in determining substance.

Findings and Analysis – OIC respondents

16. We received mixed views on whether the substance of an M&A under common control is always different from an M&A with third parties. The chart below summarises the responses to Question 3 collected by OIC.



17. The tables on the next page summarise the top factors that respondents considered important in evaluating the substance of M&As with third parties and M&As under common control (responses to Questions 4 and 5). Factors highlighted in grey are the top most important factors that are common in both situations. The last factor(s) of each table is(are) added to show factor(s) that is(are) considered less important in M&As with third parties but not M&As under common control, and vice versa.

M&As with third parties

Rank	Factor	Average rating
1	S2's business diversifies P1's business.	8.5
2	S2's business directly complements P1's business.	8.2
3	The M&A is expected to turn P1 from loss-making to profit-making.	8.2
4	The M&A is expected to bring material changes to P1's future cashflow.	7.8
5	The key management personnel and the board of directors at P1, P3 and 3rd party are independent of each other before and after the acquisition.	7.8
6	Consideration at fair market value of S2.	7.7
10	The consideration consists purely of cash.	6.9

M&As under common control

Rank	Factor	Average rating
1	The M&A is expected to bring material changes to P1's future cashflow.	8.1
2	Consideration is at fair market value of S2.	7.6
3	S2's business diversifies P1's business	7.5
4	The consideration consists purely of cash	7.5
5	The M&A is expected to turn P1 from loss-making to profit-making.	7.4
6	S2's business directly complements P1's business.	7.3
12	The key management personnel and the board of directors at P1, P3 and 3rd party are independent of each other before and after the acquisition.	6.5

18. We also identified most important factors considered by the respondents to evaluate the substance of M&As with third parties and M&As under common control. We noted that the most important factors for both M&As with third parties and for M&As under common control were:

- Acquiree's business diversifies acquirer's business.
- The M&A is expected to turn acquirer from loss-making to profit-making.
- The M&A is expected to bring material changes to acquirer's future cashflows.

19. We also analysed whether each individual respondent assigned similar ratings to these top three important factors that determine substance of an M&A. We found that at least 70% of respondents assigned a high rating (rating > 7) for the top three factors for both M&As under common control and third parties.

20. Finally, we performed an analysis to understand whether there were factors that were important for M&A under common control and less important for M&A with third parties. These factors were:

- The consideration consists purely of cash.
- Purpose of the acquisition is to achieve tax benefits for the ultimate parent company (P3).

What the joint findings tell us?

21. A majority of respondents have the perception that M&As under common control may be different from M&As with third parties.

22. However, when asked to evaluate the substance of an M&A with third parties and an M&A under common control as an equity investor of the acquirer (a listed company), respondents indicated that some factors are commonly important in both situations, for example:

    - The M&A is expected to bring material changes to acquirer's future cashflow;
    - The M&A is expected to turn the acquirer from loss-making to profit-making; and
    - Consideration is at fair value of the acquired business.

    This implies that from the investors' perspective, M&As under common control could have similar or the same substance as M&As with third parties when these factors are present in the M&A under common control.

23. Some factors are considered important when determining the substance of M&As under common control but less important in M&As with third parties. An example is when the purpose of the acquisition is to achieve tax benefits for the group.

24. Further outreach is necessary to understand:

    - why investors consider some factors more important than other factors when evaluating the substance of M&As under common control;
    - whether investors require similar information in cases where an M&A under common control has similar substance as an M&A with third parties; and
    - what information investors need when an M&A under common control has a different substance from an M&A with third parties.

25. Both HKICPA and OIC results indicate that 'synergistic effects arising from M&As' and 'an exchange that reflects fair market value' are strong considerations of transactions with substance. If we develop two methods to account for business combinations, can these factors be useful for determining which transactions should be accounted under one method over another method?

26. Lastly, we note that the response to our survey may be considered limited and not representative of the general investor community. Our interpretation of the findings may change if more responses are received.

Appendix A

List of factors for evaluating whether there is substance to M&As with third parties and M&As under common control.

1. Material changes to future cash flows of P1 are forecasted as a result of acquiring S2 group.
2. The consideration paid is based on fair market value of S2.
3. The consideration paid is nominal.
4. Underlying business purpose of the acquisition is to achieve tax benefits for entity P3.
5. Underlying business purpose of the acquisition is to streamline management reporting for entity P3.
6. Form of consideration consists purely of issuance of shares in P1.
7. Form of consideration consists purely of cash.
8. 60% of the consideration consists of share issuance in P1 and 40% consists of cash.
9. Some minority shareholders in P1 are related parties of P3.
10. All minority shareholders in P1 are third parties.
11. The key management personnel and the board of directors at P1, P2 and P3 are independent of each other before and after the acquisition.
12. There are continuing transactions between P2 and S2 after the acquisition.
13. P1 was a loss-making entity prior to the acquisition of S2. It is expected to become profit-making after the acquisition of S2.
14. S2's business directly complements P1's business.
15. S2's business diversifies P1's business.
16. P1 acquires 100% of S2.
17. P1 acquires 70% of S2.