KPMG

BRIEFING NOTE

Updated to reflect the Companies (Amendment) (No. 2) Ordinance 2018 which was effective from 1 February 2019.

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New Hong Kong Companies Ordinance

Briefing Note 3

What's new for share capital?

In previous briefing notes we have introduced the requirements of the new Companies Ordinance ("CO") (Cap. 622), to the extent they affect the preparation of financial statements and the directors' report.

In this briefing note, we focus on the changes surrounding the introduction of the no-par value regime, which impacted every Hong Kong incorporated company. Unlike the Part 9 requirements relating to financial statements and directors' reports, the new share capital regime came into operation on the commencement date of the new CO i.e. 3 March 2014.

The new regime is a simpler approach to share capital maintenance than under the old CO (Cap. 32), but may take some getting used to. So, for the avoidance of doubt, we have included a series of examples which illustrate how the regime works in practice and how companies automatically transitioned from the par value regime under the old CO.

In the appendices to this briefing note, we focus on two more areas of change for share capital:

- the updated solvency test approach to any reduction of share capital; and
- the introduction a court-free procedure for merging ("amalgamating") two companies into one.

We also review the reliefs available for mergers and group reconstructions which have been brought forward from the old CO, updated for the no-par regime, and illustrate their application through worked examples.

On 1 February 2019 the Companies (Amendment) (No. 2) Ordinance 2018 came into effect. This Amendment Ordinance, (referred to here as the 2019 Amendment Ordinance, given its effective date) aimed to clarify policy intent and remove ambiguities and inconsistencies based on experience and operational feedback from stakeholders. This briefing note has been updated to reflect those amendments and it is current as of April 2020. So far as share capital is concerned, the only impact is on eligibility for horizontal amalgamations (see page 18).

If you would like further assistance on any of the matters discussed, please talk with your usual KPMG contact. However, please also note that many of the matters discussed in this briefing note are primarily legal matters and if in doubt, expert legal advice should be sought.

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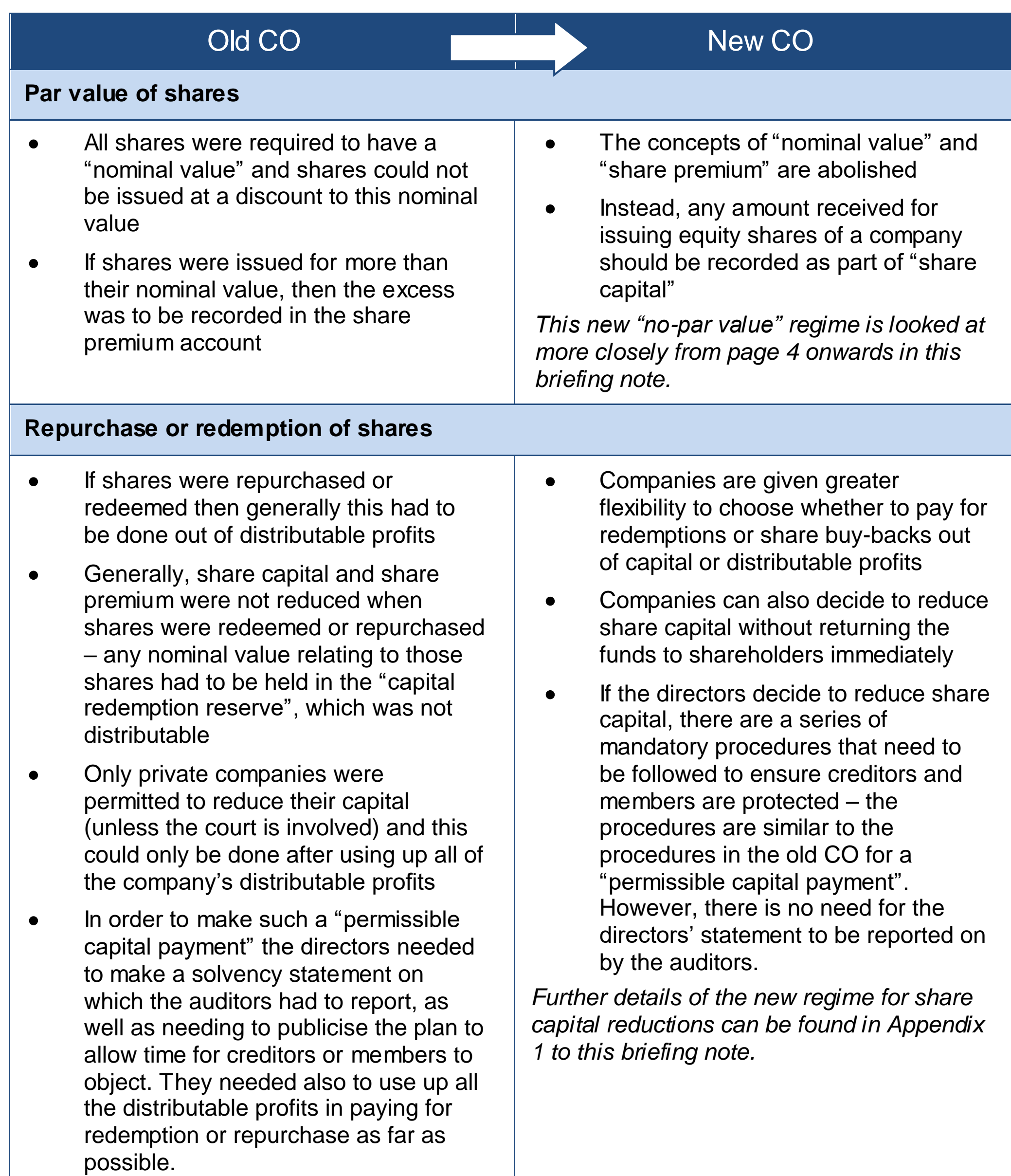
Overview of the changes

Parts 4 and 5 of the new CO (sections 134 to 289) and part 13 (sections 666 to 721) focus exclusively on share capital and transactions in share capital. Many of the basic requirements in the old CO (Cap. 32) have been brought forward into these sections, but are set out in plainer English than in the old CO.

In addition, the opportunity has been taken to (a) abandon concepts which were redundant and (b) clarify matters on which the law was previously silent. For example, section 138 states that a company no longer has the power to convert shares into stock (a concept which was rarely used in practice), while section 172 allows for share capital to be re-denominated into another currency. We recommend that those in your company responsible for company secretarial matters review these sections to establish whether any of the detailed changes are relevant for your company.

As mentioned above, there are three key areas of changes in the new CO relating to share capital to be aware of:



Old CO	New CO
Par value of shares	
• All shares were required to have a "nominal value" and shares could not be issued at a discount to this nominal value • If shares were issued for more than their nominal value, then the excess was to be recorded in the share premium account	• The concepts of "nominal value" and "share premium" are abolished • Instead, any amount received for issuing equity shares of a company should be recorded as part of "share capital" *This new "no-par value" regime is looked at more closely from page 4 onwards in this briefing note.*
Repurchase or redemption of shares	
• If shares were repurchased or redeemed then generally this had to be done out of distributable profits • Generally, share capital and share premium were not reduced when shares were redeemed or repurchased – any nominal value relating to those shares had to be held in the "capital redemption reserve", which was not distributable • Only private companies were permitted to reduce their capital (unless the court is involved) and this could only be done after using up all of the company's distributable profits • In order to make such a "permissible capital payment" the directors needed to make a solvency statement on which the auditors had to report, as well as needing to publicise the plan to allow time for creditors or members to object. They needed also to use up all the distributable profits in paying for redemption or repurchase as far as possible.	• Companies are given greater flexibility to choose whether to pay for redemptions or share buy-backs out of capital or distributable profits • Companies can also decide to reduce share capital without returning the funds to shareholders immediately • If the directors decide to reduce share capital, there are a series of mandatory procedures that need to be followed to ensure creditors and members are protected – the procedures are similar to the procedures in the old CO for a "permissible capital payment". However, there is no need for the directors' statement to be reported on by the auditors. *Further details of the new regime for share capital reductions can be found in Appendix 1 to this briefing note.*

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Old CO	New CO
Mergers, group reconstructions and amalgamations of companies	
• Relief from recording share premium was given when shares were issued to acquire 90% or more of the shares of another company (“merger relief”) or as consideration for the transfer of non-cash assets from the holding company or any of the holding company’s wholly-owned subsidiaries (“group reconstruction relief”) • Any other form of merger of companies would have been a complex legal process	• Relief is still given when shares are issued to acquire 90% or more of the shares of another company or to transfer non-cash assets within a wholly-owned group, but the detail of how the relief is computed is revised to be consistent with a no-par value regime • A new form of court-free amalgamation procedure is introduced for companies which are wholly-owned within the same group, whereby these can be amalgamated into a single legal entity *Further details of the reliefs for mergers, group reconstructions and amalgamations can be found in Appendices 2 and 3 to this briefing note.*

Is action needed by companies?

- *Companies Registry External Circular No. 2/2013 dated 1 November 2013*

Unlike the changes relating to financial statements and directors’ reports introduced in our briefing notes 1 and 2, the new share capital regime came into operation on the commencement date of the new CO i.e. 3 March 2014. This means that these changes in respect of share capital impacted a company with a December year-end one year earlier than the impact of the Part 9 changes on the financial statements and directors’ reports.

- *New CO Sch 11.35-41*

As explained in more detail on page 10 of this briefing note, the change to “no-par” shares was effected by transitional and deeming legislation in the new CO. These transitional rules aimed to:

- provide legal safeguards to ensure that any contracts which included references to “par value” and related terms were not affected by the abolition of par; and
- save time and effort for companies.

- *HK Companies Registry External Circular No.7/2012 para 16*

However, the HK Companies Registry suggested in External Circular No.7/2012 that “*individual companies may wish to review their particular situation before commencement of the new CO to determine whether or not they need to introduce more specific changes to their documents as a result of the migration to the no-par regime.”*

The Registry suggested, for example, that companies may wish to review their Memorandum, legal documents such as contracts or trust deeds entered into by the company and share certificates for use under the “no-par” regime, to see if any specific changes are needed. The Companies Registry also advised companies to seek independent legal advice if necessary.

To help with this review, in the briefing note below we outline the changes and the impact of the abolition of par value. However, we also recommend that those in your company responsible for company secretarial matters review the relevant sections of the new CO in their entirety, and/or seek legal advice, to establish whether any of the detailed changes are relevant for your company.

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Mandatory “no-par” shares for all companies with share capital

- *New CO s135*

The new CO abolishes the concept of par (or “nominal”) value for all shares in Hong Kong companies, as it was thought that it no longer satisfied its original purpose, which was the protection of creditors and shareholders. In fact, the idea of a “par value” was considered misleading as it did not represent what the shares were worth.

Consequently, the concepts of “share premium”, “capital redemption reserve” and “authorised share capital” have also been abolished.

When taken together, these changes simplify the requirements relating to share capital and give companies more flexibility when structuring their share capital.

These changes apply to:

- shares issued before and after the new legislation took effect; and
- both existing companies and new companies.

The nature of a share is still the same after these changes i.e. a share represents a fraction of ownership in a company whether or not it has a par value. The concepts of paid up capital, issued capital and partly paid shares also remain relevant.

This provision applied immediately on the date the new CO took effect, i.e. 3 March 2014, and the legislation included straightforward deeming transitional provisions to move companies onto the new rules.

Simple example of the new no-par value regime

Example 1 – Effect of the abolition of “nominal value” and “share premium”

C Ltd is a Hong Kong company, incorporated under the old CO. It has in the past issued 100 shares of nominal value $1 each and on issue received $4 per share. Under the old CO, the equity section of C Ltd’s statement of financial position at 31 December 2013 shows the following:

	Y/e 31 Dec 2013 $
Nominal value: 100 shares of $1 each in issue and fully paid	100
Share premium account	300
Statutory capital and reserves	400
Retained profits	50
Total equity	450

In 2014 there were no changes to the number of shares in issue, but C Ltd earned profits of $10. Under the new CO, the equity section of C Ltd’s statement of financial position at 31 December 2014 would show the following:

	Y/e 31 Dec 2014 $
Share capital: 100 shares in issue and fully paid	400
Retained profits	60
Total equity	460

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Uses of the share capital account

- *New CO s149 compared to old CO s48B*

Once the new CO took effect, a company's share capital account could be used in similar ways to the share premium account under the previous legislation, i.e. to write off:

- preliminary expenses of the company; or
- any commission paid under s148 of the new CO or s46 of the old CO; or
- any other expenses of any issue of shares in the company.

- *New CO Part 5 (sections 203-273) compared to old CO s49-49S*

Any other reductions in the share capital (other than on liquidation) are in general only permitted if they satisfy the requirements of Part 5 of the new CO as set out in sections 203 to 273. These sections cover share redemptions and buy-backs and other forms of reducing share capital and set out the procedures that a company needs to go through before it is permitted to reduce its share capital.

The procedures in respect of paying back share capital to shareholders are less onerous than under the old CO but nevertheless inevitably take longer, and require more effort from directors, than those requirements which apply to distribution of dividends from net accumulated realised profits. For this reason, companies should think carefully before crediting amounts to share capital voluntarily.

In the section below we look more closely at increasing the amount of share capital and/or altering the number of shares in a no-par environment. Further details on ways to reduce share capital are set out in Appendix 1 to this briefing note.

Increasing the amount of share capital and/or altering the number of shares in a no-par environment

- *New CO s170*

Section 170 of the new CO sets out the ways in which a company may increase its share capital and/or alter the number of shares in issue (other than by redeeming them or buying them back). This includes issuing new shares, capitalising profits, issuing bonus shares and effecting a share split or a share consolidation. Section 170 also includes a reminder that sections 140 and 141 require the directors to obtain shareholder approval in certain situations for some of these changes.

- *New CO s171*
- *New CO s140-144*
- *New CO s201*

If there has been any alteration in the share capital under section 170, then a notice must be delivered to the Registrar concerning the change and including a statement of capital which complies with section 201 i.e. a statement which states both the number of shares in issue and the amount of the share capital. Similar requirements apply when new shares have been allotted under section 141.

Set out below are some common examples of how share capital can increase and/or the number of shares in issue can change in a no-par regime.

Issuing new shares for fresh consideration

- *New CO s170(2)(a)*
- *New CO s140-144*

The abolition of par value means that there is no longer a minimum price at which shares may be issued. However, directors still have a fiduciary duty to act in the best interests of the company when setting the share price for any new issue of shares. It may also be necessary to obtain the shareholders' approval before issuing the new shares, if the shares are not allotted under an offer made to all member of the company in proportion to their holdings (i.e. a rights issue).

If a company issues new shares for fresh consideration, then the full proceeds will be credited to the share capital account.

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Example 2 – Issue of shares for cash consideration

Continuing example 1 on page 4: on 1st January 2015, having obtained prior approval from shareholders under s141 of the new CO, C Ltd issued 10 shares for $5 each to new subscribers, fully paid at date of issue. In 2015 it also earned profits of $15. Under the new CO, the equity section of C Ltd's statement of financial position at 31 December 2015, with comparatives for 2014, would show the following:

	Y/e 31 Dec 2015 $	Y/e 31 Dec 2014 $
Share capital: 110 shares in issue and fully paid (2014: 100 shares)	450	400
Retained profits	75	60
Total equity	525	460

Issuing bonus shares

- *New CO s170(2)(d)*
- *New CO s140(2)(b)*

A company is still able to issue bonus shares under the new "no-par" regime.

As shares have no nominal value, the company is no longer required to transfer an amount to share capital if it issues shares for no consideration, but it could chose to do so (e.g. by capitalising profits). So a company may allot and issue bonus shares either with or without increasing its share capital. Shareholder approval is not required by the new CO, provided that the bonus issue of shares is to members of the company in proportion to their shareholdings.

Example 3a: Issue of bonus shares without capitalising retained profits

Continuing example 2: on 1st January 2016 the directors of C Ltd decided to issue 1 bonus share for each 10 shares held i.e. to increase share capital from 110 shares to 121 shares. However, they decided not to capitalise any reserves. In 2016 C Ltd also earned profits of $15. Under the new CO, the equity section of C Ltd's statement of financial position at 31 December 2016, with comparatives, would show the following:

	Y/e 31 Dec 2016 $	Y/e 31 Dec 2015 $
Share capital: 121 shares in issue and fully paid (2015: 110 shares)	450	450
Retained profits	90	75
Total equity	540	525

Example 3b: Issue of bonus shares by capitalising retained profits

As an extension to the above example 3a: on 1 January 2016 the directors of C Ltd decided that in addition to issuing the bonus shares it would capitalise 1/3 of its brought forward retained profits of $75 without issuing any further shares. As mentioned in example 3a, in 2016 C Ltd earned profits of $15. Under the new CO, the equity section of C Ltd's statement of financial position at 31 December 2016, with comparatives, would show the following:

	Y/e 31 Dec 2016 $	Y/e 31 Dec 2015 $
Share capital: 121 shares in issue and fully paid (2015: 110 shares)	475	450
Retained profits	65	75
Total equity	540	525

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Share consolidations and share splits

- *New CO s170(2)(e),(3),(4)*

The new CO allows a company to convert any or all of its shares into a larger or smaller number of shares, provided that the shareholders have passed a resolution.

The resolution above may authorise the company to consolidate or split its shares:

- on more than one occasion;
- at a specified time or in particular circumstances.

Example 3c: Share consolidation

As a variation of example 3a: on 1 January 2016 C Ltd decided to consolidate its share capital by exchanging 1 new share for every 10 shares held i.e. to reduce the number of shares in issue from 110 shares to 11 shares. In 2016 it also earned profits of $15. Under the new CO, the equity section of C Ltd's statement of financial position at 31 December 2016, with comparatives, would show the following:

	Y/e 31 Dec 2016 $	Y/e 31 Dec 2015 $
Share capital: 11 shares in issue and fully paid (2015: 110 shares)	450	450
Retained profits	90	75
Total equity	540	525

Example 3d: Share split

As an alternative variation to example 3a: on 1 January 2016 C Ltd decided to replace each of the 110 shares in issue with 5 new shares. In 2016 it also earned profits of $15. Under the new CO, the equity section of C Ltd's statement of financial position at 31 December 2016, with comparatives, would show the following:

	Y/e 31 Dec 2016 $	Y/e 31 Dec 2015 $
Share capital: 550 shares in issue and fully paid (2015: 110 shares)	450	450
Retained profits	90	75
Total equity	540	525

Note:

In the above examples, the share capital note in the financial statements would report the number of shares that were actually in issue during the comparative period (2015). However, in addition:

- narrative information should be disclosed to explain that the increase or decrease in share capital was only as a result of a share split or share consolidation, as appropriate; and
- if the company discloses earnings per share, then the earnings per share for the comparative period (2015) would need to be restated to reflect the share split or share consolidation as if it had occurred at the start of that period, in order to comply with paragraph 26 of Hong Kong Accounting Standard 33, *Earnings per Share.*

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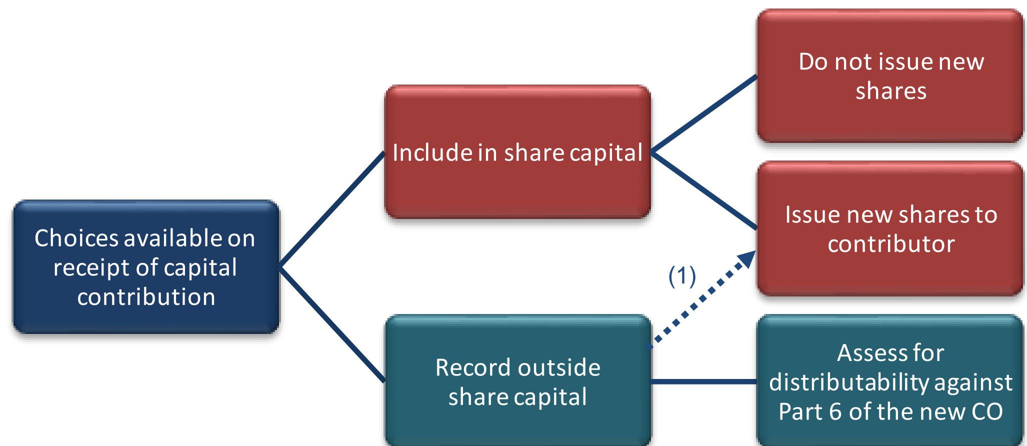
Where should a capital contribution be credited?

- *New CO s170(2)(b)*

It is a generally accepted accounting principle that when a company receives a gift from a shareholder, the amount received should be credited directly to equity. This is commonly referred to as a "capital contribution". The new CO is flexible about where the capital contribution can be recorded in equity i.e. whether within or outside share capital.

Specifically, the company has the following choices under the new CO:



(1) *According to s170(2)(d) of the new CO, a company can issue bonus shares without capitalising profits. However, if this issue is not in proportion to existing shareholdings as per s140(2), then shareholder approval is required under s141 of the new CO.*

The decision as to where to record the contribution needs to be made at the time it is received. In practice, the decisions in respect of these choices would be made as part of the arrangement with the contributor. Factors that would be considered when making the decisions would include:

- whether the purpose of the contribution was to boost share capital (for example to meet a regulatory requirement to maintain a certain level of capital) or, for example, to absorb losses; and/or
- whether the contribution was being made by all shareholders in proportion to their holdings – if not, then it is likely that the contributing shareholders will want to receive an increase in the numbers of shares they hold, to reflect their contribution to the company.

If a company decides to credit the contribution to share capital, the impact would be the same as in example 2 above, with the only difference being no change in the number of shares in issue if the company decides not to issue shares. The contribution would then be retained in the company and could only be paid back if the procedures for capital reduction were successfully completed (see Appendix 1 to this briefing note).

If the company decides instead to record the contribution outside share capital, this would leave open the possibility of returning the contribution to shareholders in the form of a dividend at a later date (or at least absorbing any realized losses and so improving the company's ability to pay dividends).

- *New CO Part 6 (s290-306, specifically s297) compared to old CO s79A-79P*

The ability to return a contribution recorded outside of share capital depends on the requirements relating to distributions of profits and assets set out in Part 6 of the new CO (sections 290-306). These sections are broadly the same as in the old CO and are based on the principle that a company may only pay a dividend, or distribute assets, out of its accumulated realized profits less its accumulated realized losses.

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- *HKICPA Accounting Bulletin 4 "Guidance on the determination of realised profits and losses in the context of distributions under the Hong Kong Companies Ordinance" and Staff Summary*

The concept of "realized" profits or losses is narrower than the concept of profits or losses "recognised" under the relevant accounting standards and therefore not every contribution received can be regarded as generating a realized profit.

For example, if a company is given a piece of real estate by its shareholders, then the capital contribution reserve arising from this gift cannot be regarded by the recipient as a "realized" profit for distribution as a cash dividend until the value of the property has been realized by selling the property for cash or a near cash asset. The only other means of distributing this reserve would be to return the property itself to shareholders in accordance with section 294.

On the other hand, if a shareholder contributes cash or waives a payable, then the contribution can be regarded as a realized profit immediately on receipt.

Further details of the principles relating to realized profits and losses can be found in the HKICPA's Accounting Bulletin 4, *Guidance on the determination of realised profits and losses in the context of distributions under the Hong Kong Companies Ordinance*, and the accompanying Staff Summary. Although as of the time of writing these materials have not been updated to refer to the new CO, the same principles continue to apply as the sections in Part 6 of the new CO have been brought forward from sections 79A to 79P of the old CO.

Example 4: Receipt of capital contribution without increasing share capital

S Ltd is a wholly owned subsidiary of P Ltd. On 31 December 2015 S Ltd's financial position was as follows:

	Y/e 31 Dec 2015 $
Various net assets	500
Loan from P Ltd	(95)
Net assets	405
Share capital: 100 shares in issue and fully paid	475
Accumulated losses	(70)
Total equity	405

On 1 January 2016 P Ltd decided to waive the loan in advance of a plan to seek additional equity investors in S Ltd. As S Ltd is wholly owned, there was no advantage to S Ltd or to P Ltd for S Ltd to issue more shares. In addition, the purpose of waiving the loan was to absorb the accumulated losses so that in future S Ltd may be able to pay dividends. Therefore S Ltd decided to credit the contribution outside share capital.

Assuming S Ltd made no other profit or loss during 2016, S Ltd's statement of financial position at 31 December 2016, including comparatives, would show the following:

	Y/e 31 Dec 2016 $	Y/e 31 Dec 2015 $
Various net assets	500	500
Loan from P Ltd	-	(95)
Net assets	500	405
Share capital: 100 shares in issue and fully paid	475	475
Distributable profits/(accumulated losses)	25	(70)
Total equity	500	405

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Transitional provisions for moving to the no-par regime

- *New CO Sch.11.35-41*

Schedule 11 to the new CO contains the transitional and saving provisions that applied to existing companies when the new CO came into effect on 3 March 2014. These included transition rules to move companies automatically on to the no par regime as follows:

Circumstances immediately before the commencement date of the new CO	Transitional provisions in Schedule 11 of the new CO
Any amounts included in a share premium account and/or capital redemption reserve	These became part of the company's "share capital" when the new legislation became effective i.e. the transition was automatic.
Liability for calls in respect of money remaining unpaid on shares	The liability of a shareholder for calls on partly paid shares issued before commencement date was not affected by the share ceasing to have a nominal value i.e. the shareholder continued to be liable.
References in contracts and other documents to par or nominal value	As shares do not have a par or nominal value under the new legislation, section 40 of Schedule 11 included rules on how to interpret a term in a contract, resolution or deed made or entered into before the commencement date of the new legislation which includes the words "par-value" or "nominal" value of a share. As we highlight in "Is action needed by companies?" on page 3, this may be one of the reasons why companies may wish to review their Memorandum and legal documents, such as contracts or trust deeds, for use under the no-par regime, to see if any specific changes are needed.

(Margin references: *New CO Sch.11.37*; *New CO Sch.11.39*; *New CO Sch.11.40*)

Impact on the financial statements of existing companies in 2014

- *New CO Sch.11.35-41*

The comprehensive transitional and deeming provisions meant that companies moved directly onto the new regime in 2014 when the new legislation took effect. As the change arose as a matter of a change of the law, it was treated as a change in circumstances and not as a change in accounting policy in the financial statements.

This is illustrated in the following example:

Example 5 – Effect of the abolition of share premium and capital redemption reserve on the statement of financial position when the new CO was first effective

D Ltd is a Hong Kong company, incorporated under the old CO (Cap. 32).

D Ltd's annual financial statements for the year ended 31 December 2013 included amounts in both the share premium account and the capital redemption reserve.

In 2014, D Ltd earned profit of $70 but did not issue or buy back any shares.

How should D Ltd have presented its equity section in 2014?

D Ltd's first annual financial statements prepared under the new CO were for the year ended 31 December 2015. However, the changes related to share capital took effect in March 2014. The equity section of D Ltd's statement of financial position for 2014, together with comparatives for 2013, would therefore be presented as follows:

(continued)

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	Y/e 31 Dec 2014 $	Y/e 31 Dec 2013 $
Nominal value of shares issued	-	100
Share premium account	-	300
Capital redemption reserve	-	50
Share Capital	450	450
Retained earnings	270	200
Total equity	720	650

This would be reflected in D Ltd's statement of changes in equity as follows:

	Share capital	Share premium	Capital redemption reserve	Retained earnings	Total equity
Balance at 1 January 2014	100	300	50	200	650
Transition to no-par value regime	350	(300)	(50)	-	-
Profits for the year				70	70
Balance at 31 December 2014	450	-	-	270	720

Did D Ltd need to take any action to effect this change?

No. D Ltd did not need to pass any resolutions or take any steps to convert the existing par value shares to no-par shares. When the new CO took effect, all shares already issued were deemed to have no par value and the share premium account and capital redemption reserve were deemed to be part of share capital.

However, as discussed above, D Ltd may have reviewed its own situation to see if it needed to make changes to its specific documents because of its particular circumstances under the no-par regime e.g. its Memorandum, contracts entered into by the company or any trust deeds.

In this briefing note, we have focused so far on the changes surrounding the introduction of the no-par value regime, which impacted every Hong Kong incorporated company. In the appendices to this briefing note, we focus on other specific aspects of the new capital maintenance regime which may be of interest from time to time as capital needs change:

- the updated solvency test approach to any reduction of share capital;
- the introduction of a court-free procedure for merging ("amalgamating") two companies into one; and
- the reliefs available for mergers and group reconstructions which have been updated for the no-par regime.

If you would like further assistance on any of the matters discussed, please feel free to talk with your usual KPMG contact.

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Appendix 1: Repurchase, redemption or other reduction of share capital based on a solvency test

As introduced on page 2 of this briefing note, the new CO has introduced flexibility into the management of share capital, while retaining aspects of the old CO designed to give protection to creditors. The new CO has also adopted a consistent approach for the procedures to be followed for various forms of reductions of share capital, whether this involves redeemable shares, share buy-backs under contract or other forms of capital reduction.

In this appendix we look more closely at these aspects of the new CO, including outlining the step-by-step procedures to be followed before share capital can be reduced and the content of the statement of solvency required from each director of a company that wishes to reduce its capital. As this text is only a summary, this appendix should not be relied upon as a substitute for referring to the original text of the various sections, schedules and regulations and seeking legal advice.

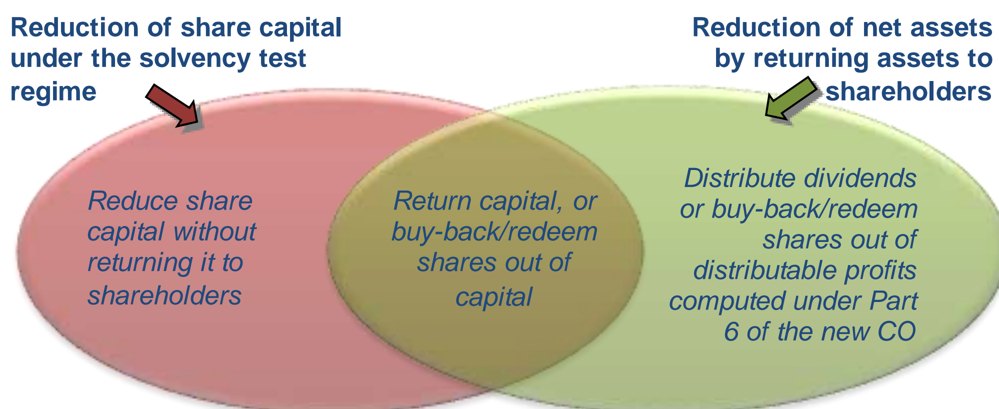
Overview: interaction of requirements relating to reduction of share capital and share buy-backs and redemptions

- *New CO Part 5 (s203-289) & Part 6 (s290-306)*

Similar to the old CO, the new CO maintains a distinction between reducing share capital and making other distributions of assets to shareholders out of distributable profits:

- Share capital can only be reduced once the directors have followed a series of approval and publicity steps, as well as making a solvency statement, primarily for the purposes of protecting creditors ("the solvency test regime").
- Other distributions to shareholders may be made at any time provided the company has sufficient distributable profits. The most common form of such distribution is a dividend, but distributable profits can also be used to finance a buy-back or redemption of shares.

The relationship between the two regimes can be summarised in the following diagram:



In the remainder of this appendix we look more closely at the requirements in Part 5 of the new CO so far as they relate to reductions of share capital and other methods by which a company may buy-back or redeem shares out of capital or chose to redeem or buy back out of distributable profits. We have included worked examples to illustrate the new flexibility in the CO and the requirements in practice.

As is explained on pages 8-9 of this briefing note, the concept of distributable profits, which is covered in Part 6 of the new CO, is broadly brought forward unchanged from sections 79A to 79P of the old CO. Further guidance on this concept can be found in the HKICPA's Accounting Bulletin 4 and accompanying Staff Summary.

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Reduction of share capital under the new solvency test regime

- *New CO s209-211*

The new CO has simplified the process by which any company may reduce its share capital. According to section 210 a company may reduce its share capital in any way provided it follows the correct procedures (these are looked at in more detail below). The examples of share capital reduction included at the end of section 210 of the new CO include:

- extinguish or reduce the liability on any share capital not fully paid up; and
- repay any paid-up share capital in excess of the wants of the company.

If a company properly reduces its share capital, but does not immediately pay out the amount of the reduction to shareholders, then section 214 explicitly states that any reserve created by the reduction is to be regarded as a realized profit under Part 6* i.e. forms part of the pool of net distributable profits (or reduces the pool of net accumulated losses) under section 297. Such amounts remain within equity but would be presented outside of share capital, for example in a "capital reserve".

The company therefore has the flexibility to undertake the legal procedures to reduce share capital at a time convenient to the company and then, at a later date, to decide whether or not the directors wish to reduce the company's net assets by returning the funds to the shareholders through a normal distribution process. This flexibility is illustrated in the following example:

*(*as explained on pages 8-9 of this briefing note, Part 6 deals with the concept of distributable reserves and is broadly brought forward from sections 79A to 79P of the old CO).*

Example 1.1: Reduction of share capital

G Ltd is an unlisted private company. On 31 December 2015 G Ltd's financial position was as follows:

	Y/e 31 Dec 2015 $
Cash at bank	500
Various other net assets	100
Net assets	600
Share capital: 100 shares in issue and fully paid	400
Retained profits (all distributable)	200
Total equity	600

The directors of G Ltd have noted that the level of share capital in the company probably exceeds the company's needs by at least 10%. As part of their discussions of this issue, they have asked the finance team to explain what the impact would be on G Ltd's statement of financial position if a reduction in capital of $40 was (a) refunded to shareholders or (b) retained in the company. The finance team's answer should be as follows:

(continued)

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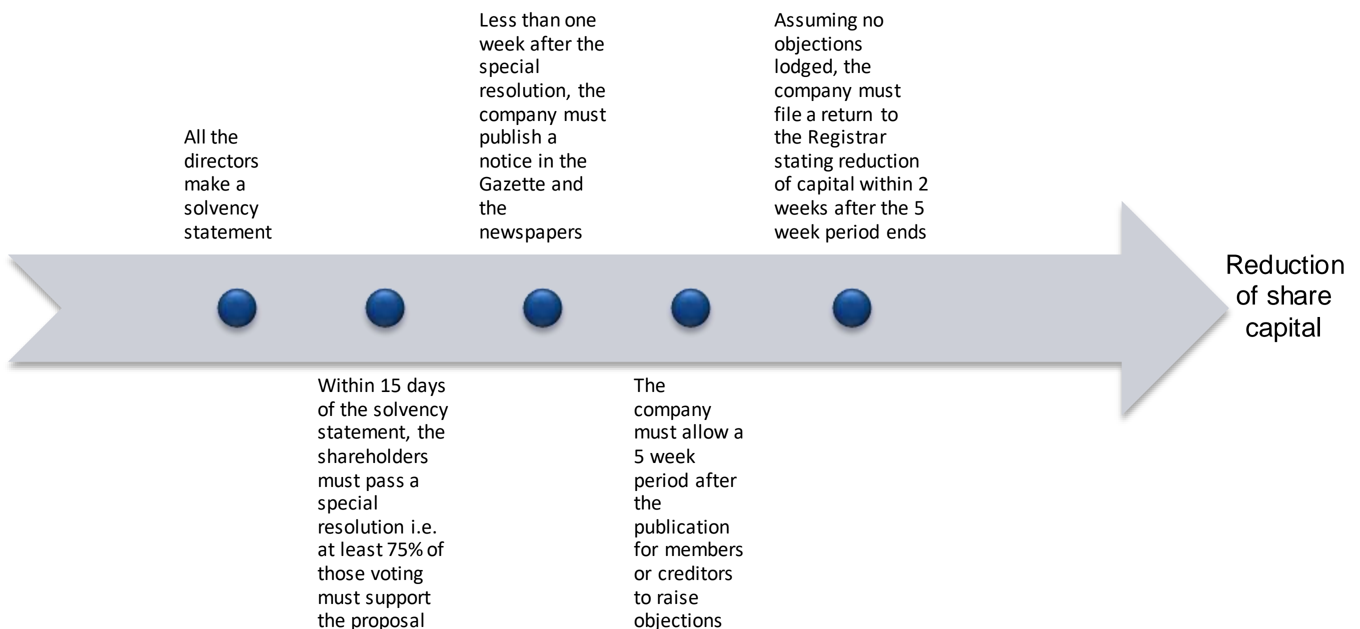
	Before $	Option (a): Re-pay shareholders? $	Option (b): Retain in the company? $
Cash at bank	500	460	500
Various other net assets	100	100	100
Net assets	600	560	600
Share capital: 100 shares in issue and fully paid	400	360	360
Capital reserve (distributable)	-	-	40
Retained profits	200	200	200
Total equity	600	560	600

Mandatory procedures for reduction of share capital

- *New CO s211-225*

The procedures to be followed under the new CO when reducing share capital provide safeguards for members and creditors of the company. They can be summarised in the following time-line, which will apply assuming there is no need to involve the courts:



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• New CO s216(1)

From the directors' perspective, the most challenging part of the above process is making the solvency statement. All the directors of the company must make this solvency statement, and the statement must comply with the requirements of sections 205-208 of the new CO.

• New CO s205-206

Requirements relating to the solvency statement

- A solvency statement is a statement that each of the directors has formed the opinion that the company satisfies the following solvency test:
  a) immediately after the share capital reduction there will be no ground on which the company could be found unable to pay its debts; and
  b) either:
     i. if it is intended to commence winding up of the company within 12 months after the date of the capital reduction, the company will be able to pays its debts in full within 12 months after the commencement of the winding up; or
     ii. in any other case, the company will be able to pay its debts as they become due during the period of 12 months immediately following the date of the transaction.
- In forming an opinion for the purpose of making a solvency statement, a director must:
  a) inquire into the company's state of affairs and prospects; and
  b) take into account all the liabilities of the company (including contingent and prospective liabilities).
- The solvency statement must:
  a) state the date on which it was made;
  b) state the name of the director making it; and
  c) be signed by each director making it.

• New CO s216(1) compared to old CO s49K(5)

There is no longer a requirement in law for the auditors to give any assurance in respect of this statement. However, in some circumstances the directors may feel more comfortable making a solvency statement if their inquiries into the company's state of affairs and prospects included engaging with the auditors and/or other external experts such as the company's financial advisors, lawyers or actuaries.

Share redemptions and buy-backs

• New CO s233-273

Part 5 of the new CO deals with the following share transactions:

- issuance and redemption of redeemable shares;
- buy-back of shares by listed companies:
  - under general offer;
  - on a recognised stock market or approved stock exchange; or
  - otherwise under contract; and
- buy-back of shares by unlisted companies under contract.

There are specific sections which deal with particular aspects of each of the above categories. However, all of the above are subject to the following general requirements:

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Section ref.	Overview of requirements applicable to all redemptions and buy-backs
S257(1)	Shares which are redeemed or bought back must be paid for at the time of the redemption or buy-back
S257(2)-(5)	The payment for the redemption or buy-back may be made: (a) out of the company's distributable profits; (b) out of the proceeds of a fresh issue of shares made for the purpose of the redemption or buy-back; or (c) out of capital, provided the necessary procedures are followed (this third option is not available for a buy-back of own shares from a recognised stock market or approved stock exchange)
S258-266	If the payment is made out of capital then the statutory procedures must be followed regarding the solvency statement by directors, the publicity for the payment out of capital and the 5 week period of allowing time for members or creditors to object – although these are set out in different sections, the procedures are in practice the same as for the reduction of capital discussed above on pages 13-15.
S268	A company must not redeem or buy-back its own shares unless they are fully paid.
S269	Shares redeemed or bought back are to be regarded as cancelled on redemption or buy-back
S270	Any redemption or buy-back of shares needs to be registered within 15 days
S271-272	A company cannot be sued for damages for failure to redeem shares or fulfill a contract to buy-back shares, and, except on winding up, it cannot be forced by the court to perform the terms of the redemption or buy-back if the company shows that it is unable to make a payment in respect of the redemption or buy-back out of distributable profits.

"Payment" for the redemption or buy-back

- *New CO s257*

When the CO refers to making "the payment" for the redemption or buy-back (or in the old CO: "financing" the redemption or buy-back), it is referring to where to record the transaction within equity i.e. where to book the debit entry when the company's net assets are reduced. The new CO introduces greater flexibility in this regard. As mentioned above, according to section 257, generally the payment may be made:

(a) out of the company's distributable profits;

(b) out of the proceeds of a fresh issue of shares made for the purpose of the redemption or buy-back; or

(c) out of share capital, provided the necessary procedures are followed (this third option is not available for a buy-back of own shares from a recognised stock market or approved stock exchange)

- *New CO s257-262 compared to old CO s49A & s49I(3)*

Unlike under the old CO, a company can choose which of the above methods to use. If it chooses to make a payment out of share capital, rather than using up distributable profits, then the same procedures as described above for a reduction of share capital apply, including the solvency statement and publicity.

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The following simplified example illustrates the impact on the statement of financial position of financing a share buy-back out of share capital or out of distributable profits:

Example 1.2: Share buy-back

Continuing Example 1.1 above: as an alternative to the general reduction of share capital, Mr X, one of the shareholders of G Ltd, has offered to sell his 10 shares back to the company at a price of $6 per share. What would be the impact on G Ltd's statement of financial position if this buy-back was paid for (a) out of distributable profits or (b) out of share capital?

	Before $	Option (a): Buy-back out of profits? $	Option (b): Buy-back out of capital? $
Cash at bank	500	440	440
Various other net assets	100	100	100
Net assets	600	540	540
Share capital: before: 100 shares, after: 90 shares	400	400	340
Retained profits	200	140	200
Total equity	600	540	540

G Ltd has sufficient distributable profits to cover this share buy-back from Mr X. If the directors use these profits, then there would be no need to make the solvency statement or publicise the buy-back (although a shareholders' special resolution under section 244 would still be required to authorise this transaction).

However, if the directors wish to keep the profits available for paying out in dividends to all the shareholders, then they would need to go through the necessary steps for the reduction of the share capital as outlined above.

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Appendix 2:
New concept: Court-free amalgamations

As introduced on page 3 of this briefing note, the new CO has introduced a new concept of amalgamations which can be used to effect group reorganisations between wholly-owned subsidiaries and their holding company and/or between wholly-owned subsidiaries of the same holding company.

In this appendix we look more closely at this new concept, including illustrating the impact on equity of amalgamating share capital in horizontal and vertical amalgamations. This guidance was updated in January and April 2017 to take into account clarifications from the Companies Registry on the question of the impact on share capital of an amalgamation and to expand the guidance on the legal effects and accounting implications of an amalgamation. As this text is only a summary and many of the matters discussed are legal matters, this appendix should not be relied upon as a substitute for referring to the original text of the various sections, schedules and regulations and seeking legal advice.

Court-free amalgamations

- *New CO s678-s686*

The new CO introduces a new concept of "amalgamations" which can be used to merge two or more companies into one company without involving the court. Two types of amalgamations are possible:

Vertical amalgamations (s680)	Horizontal amalgamations (s681)
A company may amalgamate with one or more of its wholly owned subsidiaries and continue as one company.	Two or more wholly owned subsidiaries of another body corporate[1] may amalgamate and continue as one company
Before: HoldCo; Sub 1, Sub 2 → After: HoldCo and Sub 1; Sub 2	Before: HoldCo; Sub 1, Sub 2 → After: HoldCo; Subs 1 & 2
In the case of a vertical amalgamation, the holding company is always the surviving company. So the shares of the amalgamating subsidiary or subsidiaries (here: Sub 1) will be cancelled.	In the case of a horizontal amalgamation, one of the subsidiaries will be designated as the surviving company. This means that the shares of all of the other amalgamating subsidiaries will be cancelled. So in this example, either Sub 1 or Sub 2 will be designated as the surviving entity, and the shares of the other subsidiary will be cancelled.

- *New CO s678-s686*

Various conditions need to be met before the amalgamation can take place, including shareholder approval, notifying secured creditors, publicising the amalgamation in the newspapers and the directors making a solvency statement as regards the ability of the companies concerned to be able to pay their debts as they fall due for the next 12 months, in a similar manner to the solvency statement outlined in Appendix 1.

The procedures make a distinction between an "**amalgamating**" company and the "**amalgamated**" company. An "amalgamating" company is a company which is the subject of an amalgamation proposal. It follows that each amalgamation proposal will involve two or more "amalgamating" companies. Once the amalgamation is completed, the single surviving entity is referred to as the "amalgamated" company.

[1] The 2019 Amendment Ordinance amended s678 and s681 to clarify the definition of a wholly-owned subsidiary for the purposes of this Division of the new CO. As a result of these amendments, it is now clear that wholly-owned subsidiaries may horizontally amalgamate even if their common parent is not a Hong Kong incorporated company. This is indicated by the use of "body corporate" in this definition, rather than "company" as was previously the case.

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The focus in the procedures in respect of creditors is on the unsecured creditors or those creditors whose interests are secured by a floating charge or security unattached to specific assets, as it is these creditors who may be most affected by an amalgamation of two limited liability companies which are not equal in terms of their credit worthiness. In accordance with section 686, the court has the ability to step in if the court is satisfied that giving effect to an amalgamation proposal would unfairly prejudice a member or creditor of an amalgamating company.

Specifically, the procedures are as follows:

<table>
<tr><th>Procedures</th><th>Vertical amalgamations</th><th>Horizontal amalgamations</th></tr>
<tr><td rowspan="2">Shareholder approval</td><td>(i) The shareholders of the amalgamating holding company must approve the amalgamation by way of a special resolution on a poll at a general meeting (and this cannot be by written resolution) (s680(1)(a) and (3))
(ii) The shareholders of each of the subsidiaries that are amalgamating with the holding company must also approve the amalgamation by way of a special resolution, but this can be either by poll at a general meeting or by written resolution (s680(1)(b) and (4)).</td><td>Same as (ii) for vertical amalgamations i.e. the shareholders of each of the subsidiaries that are amalgamating must approve the amalgamation by way of a special resolution, but this can be either by poll at a general meeting or by written resolution (s681(1) and (3)).</td></tr>
<tr><td colspan="2">NB a "special resolution" is a resolution passed by 75% of those voting – further details of voting requirements are in s564 of the new CO, as well as in s588 onwards</td></tr>
<tr><td>Solvency statement</td><td colspan="2">Sections 680(2)(c) and 681(2)(c) state that the terms of the amalgamation must include the condition that the directors of each amalgamating company:
(i) are satisfied that, as at the date of the solvency statement made by them, there is no ground on which the amalgamating company could be found to be unable to pays its debts;
(ii) after taking into account all the liabilities of the amalgamated company (including contingent and prospective liabilities) are satisfied that the amalgamated company will be able to pay its debts as they fall due during the period of 12 months immediately after the date on which the amalgamation is to become effective (s680(2)(c) and s681(2)(c)); and
(iii) have confirmed that as at the date of the solvency statement made by them that:
a. there exists no floating charge or other security created by the amalgamating company over a class of assets to any of which the security has not been attached; or
b. if such a charge or security exists, then each person entitled to the charge or security has consented in writing to the amalgamation proposal (s680(2)(d) and s681(2)(d)).
Section 683 states that every director who votes in favour of making a solvency statement must issue a certificate:
(a) stating that in their opinion the two solvency tests set out above within (i) and (ii) are satisfied;
(b) stating the grounds for that opinion; and
(c) stating that the conditions set out above within (iii) are satisfied.</td></tr>
<tr><td>Publicity</td><td colspan="2">Per section 682(2), the directors of each amalgamating company must:
(a) give written notice of the proposed amalgamation to every secured creditor; and
(b) publish notice of the proposed amalgamation in an English language newspaper and in a Chinese language newspaper circulating in Hong Kong.
For vertical amalgamations, this publicity must occur at least 21 days before the date of the meeting at which the holding company's poll will take place. For horizontal amalgamations approved by written resolution, this publicity must be on or before the date of circulation of the resolution.</td></tr>
<tr><td>Registration</td><td colspan="2">Section 684 sets out the details of the documents which should be delivered to the Registrar within 15 days of the approval of the amalgamation proposal.</td></tr>
</table>

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Legal effect of a successful amalgamation proposal

- *New CO s685*

According to the new CO, if the amalgamation goes ahead, then as from its effective date:

- each amalgamating company ceases to exist as a separate entity from the amalgamated company; and
- the amalgamated company succeeds to all the property, rights and privileges, and all the liabilities and obligations of each amalgamating company.

Legal and expert tax advice should be sought on understanding how this applies in practice, for example, whether after the effective date of an amalgamation any proceedings pending against an amalgamating company may be continued against the amalgamated company as a whole and how the amalgamating and amalgamated companies will be assessed for tax purposes by the Hong Kong Inland Revenue Department.

- *New CO s680(2)(a), s681(2)(a)*

Impact of the amalgamation on the shares in issue of the amalgamated (surviving) company and non-surviving company or companies

The amalgamation has no impact on the no-par shares in issue of the surviving company. That is, the number of no-par shares in issue of the surviving company after the amalgamation is simply the same as the number of no-par shares of the surviving company that were already in issue immediately prior to the amalgamation. The rights of each shareholder of the surviving company relative to the other shareholders of the surviving company (if any) are therefore unaffected by the amalgamation.

So far as the non-surviving company or companies are concerned, sections 680(2)(a) and 681(2)(a) are clear that in an amalgamation the shares of any non-surviving company are cancelled.

- *New CO s678(2), s170(2)(c), s171*

Impact of the amalgamation on the amount of share capital of the amalgamated (surviving) company

So far as the amount of share capital is concerned, section 678(2) explicitly states that an amalgamation is not a reduction of capital for the purpose of Part 5 of the CO. This is the only reference in the CO to the impact of an amalgamation on the amount of share capital and therefore raises the question as to how to deal with the share capital amount of a non-surviving company that was reported in its statement of financial position immediately prior to the amalgamation. Should the share capital of the non-surviving company be added to the share capital of the surviving company to preserve the same amount of share capital on an amalgamated basis as existed prior to the amalgamation? Or should the share capital of the surviving company remain the same as it was before the amalgamation?

This question is not specifically addressed in the CO. However, practice has now evolved in the course of companies making use of the new ability to amalgamate under the CO, which has led to the Companies Registry issuing an FAQ to clarify its position on this matter. The FAQ confirms that there is no requirement under Division 3 of Part 13 of the CO (“Amalgamation of companies within group”) for the amalgamated (surviving) company to increase its share capital upon amalgamation.[2] In other words, the share capital of the surviving company should continue to be the amount of the share capital that was reported by this company immediately prior to the amalgamation, all other things being equal.

It then follows that if the surviving company decides to include all or part of the share capital of any or all of the non-surviving companies in its own share capital, this will be a form of voluntary increase in share capital by way of capitalization of reserves which falls under section 170(2)(c). It will therefore be necessary for the surviving company to file a notice of alteration of share capital with the Companies Registry in accordance with section 171. Such a notice should be filed within one month after altering the share capital.

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[2] The Companies Registry’s FAQ was issued in March 2017 and can be found under the topic “Transactions in relation to Share Capital” in the Frequently Asked Questions section of their New CO specific topic page.

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- *New CO Part 6 (s290-306, specifically s297) compared to old CO s79A-79P*
- *HKICPA Accounting Bulletin 4 "Guidance on the determination of realised profits and losses in the context of distributions under the Hong Kong Companies Ordinance" ("AB4") and Staff Summary*

Impact on distributable reserves

As the amalgamation has no impact on the surviving company's share capital, it follows that any increase in the net assets of the surviving company which arises as a result of the amalgamation gives rise to potentially distributable reserves outside of share capital.

The distributability of these reserves will need to be established by reference to the provisions of Part 6 of the CO i.e. based on the general concept set out in section 297(2) that distributions may only be made out of accumulated net realized profits computed on an aggregate basis at the company level. This concept is brought forward from the predecessor CO as discussed on pages 8 to 9 of this briefing note.

Further details of the general principles relating to realized profits and losses can be found in the HKICPA's Accounting Bulletin 4, *Guidance on the determination of realised profits and losses in the context of distributions under the Hong Kong Companies Ordinance* ("AB4") and the accompanying Staff Summary. Although as of the time of writing these materials have not been updated to refer to the new CO, the same principles continue to apply as the relevant sections of the new CO have been brought forward from sections 79A to 79P of the old CO.

The specific issues to be considered when applying these principles to an amalgamation are as follows:

- Vertical amalgamations

  In a vertical amalgamation, the net assets of the surviving holding company will increase by the amount of the net assets of the non-surviving subsidiary or subsidiaries, less the cost of investment in those subsidiaries that was previously recognized by the surviving holding company immediately prior to the amalgamation. This is illustrated in Illustration 1 of Example 2.1 below.

  The result is that the reserves of the surviving holding company will only absorb the reserves of the non-surviving subsidiaries to the extent that those reserves arose *after* the subsidiaries were originally acquired (commonly referred to as "post-acquisition profits"). This effect on the surviving company's reserves is similar to the effect seen when preparing consolidated financial statements under accounting standards as can be seen from Illustration 1 below in Example 2.1.

  How to determine whether the additional reserves are distributable?

  Determining whether the post-acquisition reserves of any non-surviving subsidiary are distributable in the books of the surviving holding company after amalgamation is a 2-step process:

  Step 1: determining how much of these additional reserves are realized profits; and

  Step 2: adding those additional realized profits to the surviving company's other net realized profits to determine the net amount of the surviving company's distributable reserves from the date of amalgamation on an aggregate basis.

  Step 1: Determining how much of the additional reserves are "realized"

  Part 6 does not explicitly deal with how to determine whether these additional reserves appearing in the surviving holding company's books through an amalgamation are realized or unrealized. It would therefore be safe to assume that the amalgamation itself does not change the nature of these additional reserves. That is, only if the additional reserve was previously regarded as a realized profit in the books of the non-surviving company before the amalgamation, would it be regarded as a realized profit in the books of the surviving company at the date of amalgamation. As mentioned above, reference can be made to the HKICPA's AB4 for further guidance on this concept.

  Step 2: computing net distributable profits

  As distributable reserves are computed on an aggregate net basis at the company level, the distributability of the additional reserves will be impacted by the amalgamation if the holding company had accumulated realized losses immediately before the vertical amalgamation. This is because the additional reserves become part of the accumulated pot of the surviving company's reserves for the purposes of determining the aggregate amount of that company's distributable profits under Part 6 of the CO.

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For example, Company H and Sub S decide to enter into a vertical amalgamation. Immediately before the amalgamation, H has realized losses of $20 and S has realized profits of $70, of which $30 are post-acquisition. In this case, the distributable profits of the amalgamated company (H) after the amalgamation would be $10, being the net of H's pre-amalgamation realized losses of $20 and the post-acquisition profits of $30 which have been amalgamated from S.

Similarly, if the non-surviving subsidiary or subsidiaries had post-acquisition accumulated realized losses immediately before the amalgamation, then after the amalgamation the surviving holding company's ability to make a distribution will be reduced by these losses.

- Horizontal amalgamations

  The steps outlined in the discussion above concerning how to determine whether the additional reserves are distributable are applicable to a horizontal amalgamation, as well as to a vertical amalgamation.

  However, there are 2 key differences to note:

  1. In a horizontal amalgamation there will be no cost of investment to eliminate. Therefore, all of the reserves from the non-surviving company or companies will be amalgamated into the surviving company's books, regardless of whether those reserves are pre-acquisition or post-acquisition reserves from the common holding company's perspective; and
  2. In a horizontal amalgamation an amount representing the non-surviving companies' share capital will also be recognized outside of the surviving company's share capital in a reserve (in the examples below we have called this an "other reserve").

  This is illustrated in Illustrations 2 and 3 of Example 2.1 below.

  Is the "other reserve" arising in a horizontal amalgamation a realized profit?

  As the "other reserve" represents amounts that were previously share capital in the non-surviving company's or companies' books, the question of "realized" or "unrealized" for these amounts will not have been addressed before. Also it appears that the "other reserve" cannot be assumed automatically to be realized in accordance with section 214 of Part 5, as section 678(2) states that an amalgamation is not a reduction of capital for the purpose of Part 5 of the CO.

  Instead the principles of AB4 can be considered. These principles would look to whether the reserve originally arose from the receipt of "qualifying consideration", and, if not, whether the reserve became realized later, as a result of the subsequent receipt of qualifying consideration or impairment.

  For example:

  - if the non-surviving company received cash when it originally issued its shares, then this was a form of "qualifying consideration" and therefore it would seem reasonable to regard the "other reserve" which arises when this company is amalgamated with its fellow subsidiary as a form of "realized profit".

  - However, if those shares were originally issued in exchange for a property then the assessment of whether this "other reserve" is realized or unrealized at the time of the amalgamation would be more complex as a property is an illiquid asset. In such cases it would depend on whether the property is still held by the non-surviving company immediately before the amalgamation. If the property is still held and carried at the same or more than the original amount, then the reserve is a still form of unrealized profit for the time being, as the property is not a form of "qualifying consideration". However, if the property had already been sold for qualifying consideration (e.g. cash) then the "other reserve" could reasonably be regarded as realized. Similarly, if an impairment loss had been recognized against the property's carrying value, then the "other reserve" could reasonably be regarded as realized to the extent of the loss recognized.

  Further guidance on qualifying consideration and realized profits can be found in AB4.

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How should an amalgamation be recognized in the surviving company's financial statements?

- *HKICPA Accounting Guideline 5 "Merger Accounting for Common Control Combinations"*

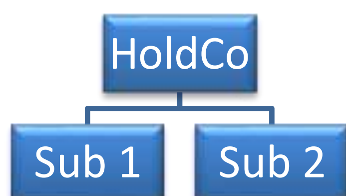
As amalgamations are a new concept for Hong Kong, there is no specific accounting guidance yet from the HKICPA. However, in a series of Frequently Asked Questions issued by the HKICPA in September 2018, the HKICPA confirmed that, as all such amalgamations can only occur within wholly-owned groups under the new CO, reference can be made to the HKICPA's Accounting Guideline 5, *Merger Accounting for Common Control Combinations*. This Guideline sets out a generally accepted methodology for accounting for two or more entities as if they had always been part of the same group as from the date that common control for these entities first occurred. This includes bringing in all assets and liabilities at their carrying amounts in the previous financial statements from the controlling parent's perspective and restating comparative amounts to include the combined history of the entities.

In the absence of any requirements from the HKICPA, other approaches to recognizing common control combinations, for example recognizing the additional net assets from the date of amalgamation rather than restating comparatives, may also be acceptable. It is therefore important that the financial statements of the surviving company clearly disclose the approach taken, and that consideration is given to how the pre- and post-amalgamation results relating to the non-surviving companies will be reported to the relevant authorities for tax purposes.

The adjustments required to effect a vertical or horizontal amalgamation are illustrated in the following simple example:

Example 2.1: Illustration of the impact on equity of horizontal and vertical amalgamations

The simplified example below illustrates the financial reporting impact of amalgamating two companies under Part 13 of the new CO for a group consisting of 3 companies. The group structure before the amalgamation is as follows:



Sub 1 is a wholly-owned subsidiary acquired several years ago when Sub 1's statement of financial position was as follows:

Net assets (at fair value)	*85*
Share capital	*35*
Retained profits	*50*
Total equity	*85*

As Holdco paid $100 when the fair value of Sub 1's net assets was $85, $15 goodwill arose on acquisition of Sub 1.

Sub 2 has been wholly owned by HoldCo since the date of its incorporation.

Immediately prior to the date of amalgamation the individual statements of financial position of each group company and the consolidated statement of financial position of the group were as follows:

	Company-level			Consolidation journals		Consolidated group
	HoldCo	Sub 1	Sub 2	Re Sub 1	Re Sub 2	
Investment in Sub 1 & Sub 2	110	-	-	(100)	(10)	-
Goodwill				15		15
Other net assets	60	125	80	-	-	265
Net assets	170	125	80	(85)	(10)	280
Share capital	110	35	10	(35)	(10)	110
Retained profits	60	90	70	(50)	-	170
Total equity	170	125	80	(85)	(10)	280

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In such a group various amalgamations are possible:

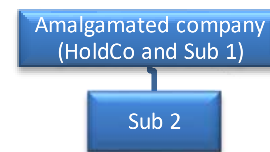
- HoldCo could vertically amalgamate with either Sub 1 or Sub 2 or with both of these subsidiaries; or
- Sub 1 and Sub 2 could horizontally amalgamate with each other, with either Sub 1 or Sub 2 being designated as the surviving "amalgamated" company.

In each case, the impact of the amalgamation will be on the standalone financial statements of the surviving amalgamated company. However, there will be no impact on the consolidated financial statements of the group as a whole. This is demonstrated in the following illustrations of vertical and horizontal amalgamations.

Illustration (1): Vertical amalgamation of HoldCo and Sub 1 under section 680:

Before:

After:



In a vertical amalgamation, the cost of the investment in the amalgamating subsidiary (here an investment of $100 in Sub 1) is replaced by bringing up all of that subsidiary's identifiable assets and liabilities into HoldCo's company-level statement of financial position in the same way as if consolidating that subsidiary i.e. including eliminating Sub 1's share capital and pre-acquisition retained earnings and recognising goodwill. The workings would be as follows:

	Amalgamating companies		Adjustments on amalgamation	Amalgamated HoldCo
	HoldCo	Sub 1		
Investment in subsidiaries	110	-	(100)	10
Goodwill			15	15
Other net assets	60	125		185
Net assets	170	125	(85)	210
Share capital	110	35	(35)	110
Retained profits	60	90	(50)	100
Total equity	170	125	(85)	210

The effect of the vertical amalgamation is to increase HoldCo's own net assets and retained profits by the amount of Sub 1's post-acquisition profits (i.e. an increase in HoldCo's net assets of $40, from $170 to $210). The goodwill of $15 which arose on the original acquisition of Sub 1 appears on HoldCo's own statement of financial position, in the same way as it would have done, if Sub 1 had been an unincorporated business when it was first acquired by HoldCo.

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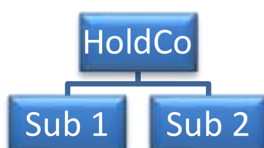
After amalgamation the consolidated statement of financial position for the whole group would be computed as follows:

	The group after the amalgamation				Before
	Company level				
	Amalga-mated HoldCo	Sub 2	Consolidation journal re Sub 2	Consolidated group	Consolidated group
Investment in subsidiaries	10	-	(10)	-	-
Goodwill	15			15	15
Other net assets	185	80	-	265	265
Net assets	210	80	(10)	280	280
Share capital	110	10	(10)	110	110
Retained profits	100	70	-	170	170
Total equity	210	80	(10)	280	280

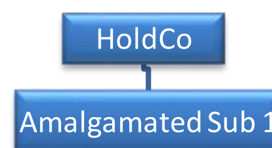
It can be seen from comparing the consolidated statement of financial position before and after the amalgamation, that the vertical amalgamation of Sub 1 into HoldCo's own financial statements has had no impact on the consolidated statement of financial position for the group as a whole.

Illustration (2): Horizontal amalgamation of Sub 1 and Sub 2 under section 681, with Sub 1 surviving:

Before:



After:



In a horizontal amalgamation, the non-surviving subsidiary's identifiable assets and liabilities are included into the surviving subsidiary's company-level statement of financial position. The workings would be as follows:

	Amalgamating companies			
	Sub 1	Sub 2	Adjustments on amalgamation	Amalgamated Sub 1
Investment in subsidiaries	-	-	-	-
Goodwill			-	-
Other net assets	125	80		205
Net assets	125	80	-	205
Share capital	35	10	(10)	35
Other reserves			10	10
Retained profits	90	70	-	160
Total equity	125	80	-	205

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The effect of the amalgamation is to increase Sub 1's own net assets and retained profits by the amount of Sub 2's net assets (i.e. an increase in Sub 1's net assets of $80, from $125 to $205). Sub 1's share capital remains unaltered at $35 and therefore an "other reserve" is created outside of share capital to record the amount that Sub 2 previously recorded as share capital ($10).

As mentioned above, the distributability of this "other reserve" will need to be established by reference to the provisions of Part 6 of the CO i.e. based on the concept of making distributions out of accumulated net realized profits. This concept is brought forward from the predecessor CO as discussed on pages 8 to 9 of this Briefing Note and similar considerations apply to horizontal amalgamations as apply when assessing whether a capital contribution is realized profit (as discussed on those earlier pages). That is, the distributability of this other reserve depends on whether this reserve can be traced back to a receipt of qualifying consideration or not.

For example, in this worked example, if Sub 2 had originally received the $10 in cash from HoldCo in exchange for issuing its shares, then the "other reserve" arising on amalgamation with Sub 1 would be a form of realized profit in Sub 1's books as the original cash received was a form of "qualifying consideration". The "other reserve" would therefore be able to be included in computing Sub 1's accumulated realized profits less its accumulated realized losses. However, if Sub 2's shares were originally issued in exchange for non-cash assets then the assessment of whether this "other reserve" is realized or unrealized would be more complex, and would depend on whether the non-cash assets were still held by Sub 2 immediately before the amalgamation.

If the group decided instead that some or all of Sub 2's share capital amount should be capitalised to increase Sub 1's share capital, we understand that the Companies Registry would regard this as a form of increase in share capital in accordance with section 170(2)(c). It would therefore be necessary for Sub 1 to file a return under section 171 within one month of the increase.

So far as HoldCo is concerned, the horizontal amalgamation of Sub 1 and Sub 2 has no impact on its company-level financial statement of position. Instead, after the amalgamation, the cost of investment in subsidiaries of $110 simply represents the cost of investment in the amalgamated Sub 1, as this subsidiary now includes all of the net assets of non-surviving Sub 2. The consolidated statement of financial position for this group would be computed as follows:

	The group after the amalgamation				Before
	Company level				
	HoldCo	Amalga-mated Sub 1	Consolidation journal	Consolidated group	Consolidated group
Investment in subsidiaries	110	-	(110)	-	-
Goodwill		-	15	15	15
Other net assets	60	205	-	265	265
Net assets	170	205	(95)	280	280
Share capital	110	35	(35)	110	110
Other reserve		10	(10)	-	
Retained profits	60	160	(50)	170	170
Total equity	170	205	(95)	280	280

It can be seen from comparing the consolidated statement of financial position before and after the amalgamation, that the horizontal amalgamation of Sub 1 and Sub 2 has had no impact on the consolidated statement of financial position for the group as a whole.

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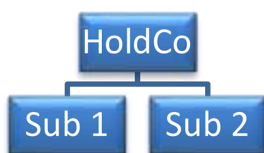
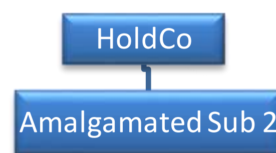
Illustration (3): Horizontal amalgamation of Sub 1 and Sub 2 under section 681, with Sub 2 surviving:

Before:

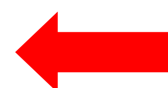


After:



If Sub 2 was designated as the surviving company, rather than Sub 1, the only difference compared to Illustration 2 would be in the amount of the share capital and other reserve. This can be seen from the following workings:

	Amalgamating companies		Adjustments on amalgamation	Amalgamated Sub 2
	Sub 1	Sub 2		
Other net assets	125	80	-	205
Net assets	125	80	-	205
Share capital	35	10	(35)	10
Other reserves			35	35
Retained profits	90	70	-	160
Total equity	125	80	-	205



After this amalgamation the group consists only of HoldCo and Sub 2. The consolidated statement of financial position for this group would be computed as follows:

	The group after the amalgamation				Before
	Company level				
	HoldCo	Amalga-mated Sub 2	Consolidation journal	Consolidated group	Consolidated group
Investment in subsidiaries	110	-	(110)	-	-
Goodwill		-	15	15	15
Other net assets	60	205	-	265	265
Net assets	170	205	(95)	280	280
Share capital	110	10	(10)	110	110
Other reserve		35	(35)		
Retained profits	60	160	(50)	170	170
Total equity	170	205	(95)	280	280

It can be seen from comparing Illustration 2 and Illustration 3 that it makes no difference to the consolidated financial statements whether Sub 1 or Sub 2 is designated as the surviving company.

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Appendix 3
Updated reliefs for mergers and group reconstructions

As introduced on page 3 of this briefing note, the new CO has retained the concepts of merger relief and group reconstruction relief which apply in certain situations where shares are issued to acquire another company or assets from another group company, but has changed the detail in respect of how the amounts of relief are computed.

In this appendix we look more closely at these aspects of the new CO, including illustrating the importance of taking the reliefs at the time when they are on offer, in order to facilitate profit distribution at a later date. As this text is only a summary, this appendix should not be relied upon as a substitute for referring to the original text of the various sections, schedules and regulations and seeking legal advice.

Merger relief

What is merger relief?

- *New CO s196-199 compared to old CO s48C*

"Merger relief" is the relief from recording part of the consideration received in share capital. It is given under both the old and the new CO if a company obtains at least a 90% equity holding in another company by issuing its own equity shares as consideration. From an accounting perspective the relief is reflected in the company-level financial statements.

Merger relief is important because of the restrictions on making distributions out of share capital. By giving relief from recording amounts in share capital it prevents a "dividend trap" arising in a parent. A "dividend trap" is when pre-acquisition distributable profits are blocked from onward distribution at the parent company level.

Why is merger relief still relevant?

- *Old CO s48C*

Under the old CO, a company taking merger relief was not required to record any premium on the issue of shares in its share premium account if certain criteria were met. The shares issued were therefore only recorded at their nominal or par value.

- *New CO s135*

Now that the new CO has become effective, shares longer have a nominal value and a company no longer has a share premium account. But this does not make the concept of "merger relief" redundant: without merger relief the consideration received from issuing shares would still need to be recorded in share capital under the new CO, and there continues to be a difference in the CO between the rules on making distributions out of profits and out of share capital. So the need to prevent "dividend traps" still exists under the new CO.

- *New CO s196-197*

However, as there is no longer the concept of "par value" and "share premium", the amount at which the issuing company records the shares when taking merger relief is calculated differently under the new legislation.

Computing merger relief under the new CO

- *New CO s196(2)*

The new CO changes the way merger relief is calculated as reference can no longer be made to par value and share premium. Instead, the new CO states that when a company meets the conditions for merger relief, the minimum that it must record as consideration for the issue of the shares is the "subscribed capital" attributable to the shares of the other company it has acquired. It can ignore any excess of the value of the equity shares acquired, or cancelled, over the subscribed share capital of the subsidiary acquired.

The example below illustrates the impact on the parent company's statement of financial position of taking and not taking merger relief under the new CO:

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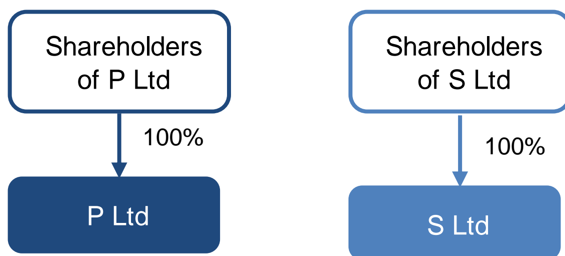
Example 3.1 – Impact of merger relief under the new CO

On 31 December 2014, P Ltd issued 50,000 of its own equity shares to the shareholders of S Ltd in exchange for all their shares in S Ltd.

As S Ltd was previously owned by third parties, P Ltd records the investment in S Ltd at fair value in its stand-alone statement of financial position. At the time of gaining control over S Ltd, P Ltd's shares were trading at $4.80 per share. So the fair value of the consideration given for 100% of the equity of S Ltd (being 50,000 shares in P Ltd) is measured at $240,000.

The structure ***before*** the share swap is as follows:

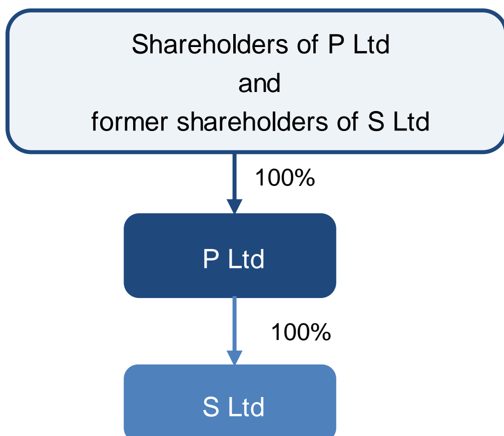


The statement of financial position of the two companies at 31 December 2014, immediately ***before*** the share swap is as follows:

	P Ltd	S Ltd
	$'000	$'000
Sundry net assets	500	200
Share capital	200	50
Retained profits	300	150
Total equity	500	200

After the share swap …

The structure after the share swap is as follows:



The company-level statement of financial position of P Ltd under the new CO immediately after the share swap, without and with merger relief[1], would be:

	Without merger relief	With merger relief
	$'000	$'000
Sundry net assets	500	500
Investment in S Ltd	240	240
Net assets	740	740
Share capital[1]	440	250
Merger reserve[1]	-	190
Retained profits	300	300
Total equity	740	740

Note 1:

Merger relief is optional – at the time of acquiring all the equity in S Ltd (i.e. 31 December 2014) P Ltd had the choice whether or not to take advantage of the relief:

- *If P Ltd did not take advantage of merger relief then P Ltd's share capital would have increased by the full amount of the consideration for the shares issued i.e. it would have increased by $240,000 from $200,000 to $440,000.*
- *If P Ltd took advantage of the relief then P Ltd's share capital only needed to increase by the amount of the subscribed capital acquired. In this example, this would be $50,000 (i.e. 100% of the carrying value of S Ltd's share capital at acquisition). P Ltd's share capital therefore would have increased from $200,000 to $250,000. The balance of the consideration (being $240,000 less $50,000 = $190,000) would have been recorded in a merger reserve which sits in P Ltd's equity outside the statutory measure of "share capital".*

Note that the decision to take the relief must be made at the time when the subsidiary is acquired. The parent cannot decide retrospectively to take merger relief in a later year.

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Merger relief – what is the impact on distributable profits if the subsidiary pays a dividend to the parent out of pre-acquisition distributable profits?

- *New CO Part 6 (in particular s297)*
- *Accounting Bulletin 4 issued by the HKICPA*

As outlined above, the benefit of taking merger relief is that a merger reserve can become a distributable reserve under Part 6 of the new CO (i.e. primarily section 297) if the subsidiary pays up a dividend in the form of a cash or near cash asset.

To illustrate the benefit of taking merger relief, we continue the previous example and consider the case of a subsidiary which pays a dividend to its parent out of its pre-acquisition profits and the parent prepares its financial statements under HKFRSs.

- *HKAS 27.12*

HKAS 27, *Separate Financial Statements*, requires that a dividend from a subsidiary must be recognised in profit and loss in the parent's stand-alone financial statements and cannot be offset against the investment in the subsidiary. For this purposes it is irrelevant whether the dividend is paid out of pre- or post-acquisition profits.

- *HKAS 36.12(h)*

However, HKAS 36, *Impairment of Assets,* requires that a parent must record an impairment of its investment in a subsidiary if the recoverable amount of its investment falls to below its carrying value (or cost) in the parent's balance sheet. This may happen if a subsidiary pays a dividend out of pre-acquisition profits, particularly if the payment is shortly after acquisition.

We continue with the previous example to illustrate how the merger reserve may become realised if there is a subsequent impairment of the investment in the subsidiary.

Continuing on from Example 3.1 – Impact on distributable profits if merger relief is taken

On 1 January 2015, immediately after the share-for-share exchange, S Ltd distributes all its retained profit of $150,000 to P Ltd.

- *HKAS 36.12(h)*

In its stand-alone financial statements, P Ltd recognises the dividend received/receivable in profit and loss, but then carries out an impairment review on its investment in S Ltd as:

- the carrying value of the investment of S Ltd in P Ltd's separate financial statements exceeds the carrying amount of S Ltd's net assets in P Ltd's consolidated financial statements: and
- the dividend exceeds the total comprehensive income of S Ltd in the period the dividend is declared.

P Ltd determines that it must impair its investment in S Ltd by $150,000 as a result of the distribution.

What would be the impact on the distributable profits of P Ltd? Would taking merger relief have made a difference? The analysis would be as follows:

Analysis

In P Ltd's company-level financial statements, the initial accounting entries to recognise the dividend and the impairment loss would be as follows:

	$'000	$'000		$'000	$'000
Dividend income:			*Impairment loss:*		
Dr Dividend receivable / cash	150		Cr Investment in S Ltd		150
Cr Income statement		150	Dr Income statement	150	

In other words, because P Ltd has to recognize an impairment loss at the same time as the dividend income, it is not able to show a net profit in its income statement in this example. Taking advantage of merger relief would have made no difference to this accounting presentation of P Ltd's lack of real income in 2015.

Nevertheless, taking advantage of merger relief would have helped P Ltd avoid this dividend trap. Here's how this works:

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P Ltd without merger relief	Before distribution	After distribution
	$'000	$'000
Sundry net assets	500	500
Dividend receivable from S Ltd	-	150
Investment in S Ltd	240	90
Net assets	740	740
Share capital	440	440
Retained profits	300	300
Total equity	740	740

The above illustrates that if P Ltd has not taken merger relief, then the receipt of the dividend from S Ltd cannot increase P Ltd's distributable reserves, because its effect is offset by the subsequent impairment of the investment in S Ltd. The dividend is effectively "trapped" at P Ltd's level.

In this case, the only way for P Ltd to be able to pass this dividend upwards on to its own shareholders would be to go through a formal share capital reduction under the solvency test regime, as introduced in Appendix 1 to this briefing note.

P Ltd with merger relief	Before distribution	After distribution
	$'000	$'000
Sundry net assets	500	500
Dividend receivable from S Ltd	-	150
Investment in S Ltd	240	90
Net assets	740	740
Share capital	250	250
Merger reserve	190	40
Retained profits	300	450
Total equity	740	740

If P Ltd has taken merger relief, then the merger reserve would be available to offset the impairment of the investment in S Ltd in accordance with Part 6 of the new CO. So in this example, $150,000 of that reserve can be regarded as realised. This has been reflected above by transferring $150,000 from the merger reserve to retained profits.

This means that, as a result of P Ltd taking advantage of merger relief, $150,000 pre-acquisition distributable profits of S Ltd (the subsidiary) paid up as dividends to P Ltd (the parent) are still available for onward distribution by the parent under the Part 6 distributable profits regime.

Merger relief in new parent formation and common control situations

- *New CO s196(2), 198*
- *HKAS 27.13*
- *KPMG International's publication "Insights into IFRSs" section 5.13.110*

As discussed above, when a company meets the conditions for merger relief and chooses to take advantage of it, the new CO requires that the minimum that it must record as consideration for the issue of the shares is the "subscribed capital" attributable to the shares of the other company it has acquired. It can ignore any excess of the value of the equity shares acquired, or cancelled, over the subscribed share capital of the subsidiary acquired.

The new CO does not contain any other specific requirements relating to the value at which the investment in the new subsidiary must be stated, as this is a matter for accounting standards. In Example 3.1 above, we illustrated the case of an acquisition of a subsidiary from a third party and in this case, the cost of the investment was stated at fair value, with the difference between this and the statutory amount of "share capital" being recorded in a "merger reserve". However, the treatment may be different if the new subsidiary was acquired by a newly set-up parent company or otherwise in a common control situation.

Specifically, the current situation under HKFRSs is as follows:

- paragraphs 13-14 of HKAS 27 specify the amount to be recognised as the cost of the investment in the subsidiary when a new parent is inserted above an existing company (the existing company may itself be a parent or a stand-alone company) – this is looked at more closely in Example 3.2 below
- in all other cases of an entity gaining control over another entity by issuing shares in a common control situation, in our view companies can make an accounting policy choice of either book value accounting or fair value accounting, as discussed in section 5.13.110 of our publication *Insights into IFRS*, issued by KPMG International. This choice arises as

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a result of the common control exemption currently set out in IFRS 3 *Business Combinations* and consequently HKFRS 3 of the same name.

Example 3.2 – Interaction of merger relief under the new CO and HKAS 27.13-14

On 31 December 2014, OpCo Ltd established a new entity HoldCo Ltd. HoldCo's only transaction on that day is to issue 50,000 of its own equity shares to the shareholders of OpCo in exchange for all their shares in OpCo.

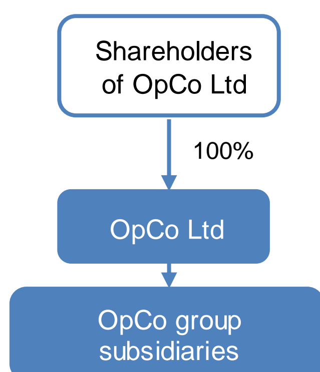
This transaction falls within the scope of HKAS 27.13 as it meets the three conditions in HKAS 27.13:

a) HoldCo obtains control of OpCo by issuing its own equity instruments in exchange for OpCo's equity instruments

b) the assets and liabilities of the new group (headed by HoldCo) and the original group (headed by OpCo) are the same immediately before and after the reorganisation; and

c) the owners of OpCo before the reorganisation have the same absolute and relative interests in the net assets of the OpCo group and the HoldCo group immediately before and after the reorganisation.

The structure before the share swap is as follows:



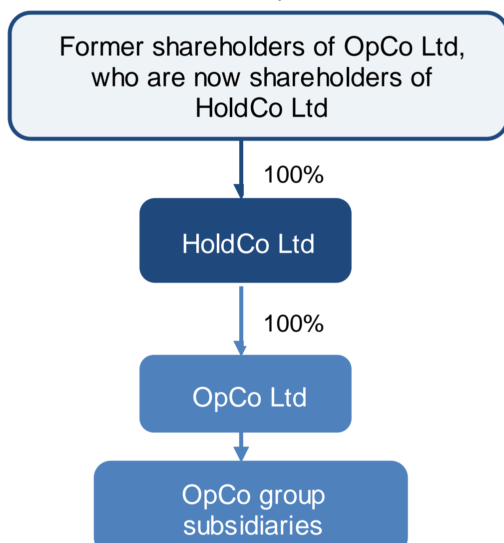
OpCo's company-level statement of financial position at 31 December 2014, immediately before the share swap is as follows:

	OpCo Ltd
	$'000
Investment in subsidiaries and other sundry net assets	200
Share capital	50
Retained profits	150
Total equity	200

After the formation of HoldCo and the share swap ...

As the reorganisation falls within the scope of HKAS 27.13, HoldCo is required by HKAS 27.13 to record the cost of its investment in OpCo at its share of the equity items shown in the company-level financial statements of OpCo at the date of the reorganisation (which in this example is a 100% share). HoldCo's company-level statement of financial position under the new CO immediately after the share swap, without and with merger relief, would be as follows:

The structure after the share swap is as follows:



HoldCo's company-level statement of financial position after the share swap

	Without merger relief	With merger relief
	$'000	$'000
Investment in OpCo Ltd	200	200
Sundry net assets	-	-
Net assets	200	200
Share capital[1]	200	50
Merger reserve[1]	-	150
Retained profits	-	-
Total equity	200	200

(continued)

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Note 1:

Merger relief is optional – at the time of acquiring all the equity in OpCo, HoldCo can choose whether or not to take advantage of the relief:

- *If HoldCo does not take advantage of merger relief then HoldCo's share capital is stated at the full amount of the consideration recorded under HKAS 27.13 for the shares issued i.e. $200,000.*
- *If HoldCo does take advantage of the relief then HoldCo's share capital only needs to increase by the amount of the subscribed capital acquired. In this example, this would be $50,000 (i.e. 100% of the carrying value of OpCo's share capital at acquisition). The balance of the consideration computed under HKAS 27.13 (being $200,000 less $50,000 = $150,000) is recorded in a merger reserve which sits in HoldCo Ltd's equity outside the statutory measure of "share capital".*

Note that the decision to take the relief must be made at the time when the subsidiary is acquired. The parent cannot decide retrospectively to take merger relief in a later year.

What difference does following HKAS 27.13 make?

As shown in the above Example 3.2, HKAS 27.13 limits the amount that can be recorded as the cost of the investment to the new parent's share of the subsidiary's equity (in the above example that share was 100%). By contrast in Example 3.1, the investment in S Ltd was recorded at fair value, which will be greater than the subsidiary's equity in the case of profits retained further down the group, unrecorded goodwill and other off-balance sheet intangibles, such as customer relationships.

This difference is illustrated in the above two examples: S Ltd and OpCo Ltd had identical statements of financial position prior to the share swap, but P Ltd in Example 3.1 records its investment in S Ltd at fair value of $240,000, while HoldCo Ltd in Example 3.2 records its investment in OpCo Ltd at a deemed cost of $200,000 computed under HKAS 27.13.

So what would happen if on 1 January 2015, immediately after the share-for-share exchange, OpCo Ltd, like S Ltd, distributes all its retained profit of $150,000 to HoldCo Ltd? The continuation of Example 3.2 would be as follows:

- *HKAS 36.12(h)*

Continuation of Example 3.2: what happens when a distribution is paid by OpCo Ltd?

In its stand-alone financial statements, HoldCo, like P Ltd in Example 3.1, recognises the dividend received/receivable in profit and loss, and then carries out an impairment review on its investment in OpCo as specifically required by HKAS 36.12(h) since:

- the carrying value of the investment in OpCo in HoldCo's separate financial statements (i.e. $200,000) exceeds the carrying amount of OpCo's net assets in HoldCo's consolidated financial statements after the declaration of the dividend: and
- the dividend exceeds the total comprehensive income of OpCo in the period the dividend is declared.

HoldCo estimates that the recoverable amount of its equity investment in OpCo, after OpCo has declared the dividend, is $90,000, based on its estimates of the higher of OpCo's fair value less costs of disposal and value in use. As a result, HoldCo identifies that it needs to impair its investment in OpCo by $110,000 as a result of the distribution.

What would be the impact on the distributable profits of HoldCo? Would taking merger relief have made a difference? The analysis would be as follows:

(continued)

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Analysis

Whether or not HoldCo had taken advantage of merger relief, in HoldCo's company-level financial statements the accounting entries to recognize the dividend income and impairment loss would be as follows:

	$'000	$'000		$'000	$'000
Dividend income:			*Impairment loss:*		
Dr Dividend receivable / cash	150		Cr Investment in OpCo		110
Cr Income statement		150	Dr Income statement	110	

In other words, because HoldCo has to recognize an impairment loss at the same time as the dividend income, it is only able to show a net profit in its income statement of $40,000 in this example. Taking advantage of merger relief would have made no difference to this accounting presentation of HoldCo's income in 2015.

Nevertheless, as in Example 3.1, taking advantage of merger relief would have helped HoldCo avoid a dividend trap, as can be seen from the following:

HoldCo Ltd without merger relief

	Before distribution	After distribution
	$'000	$'000
Sundry net assets	-	-
Dividend receivable from OpCo	-	150
Investment in OpCo	200	90
Net assets	200	240
Share capital	200	200
Retained profits	-	40
Total equity	200	240

The above illustrates that if HoldCo does not take advantage of merger relief, then the receipt of the dividend from OpCo can only increase HoldCo's distributable reserves by the net amount recorded in the income statement i.e. $110,000 of the dividend is "trapped" at HoldCo's level.

In this case, the only way for HoldCo to be able to pass the full amount of this dividend on to its own shareholders would be to go through a share capital reduction under the solvency test regime, as introduced in Appendix 1 to this briefing note.

HoldCo Ltd with merger relief

	Before distribution	After distribution
	$'000	$'000
Sundry net assets	-	-
Dividend receivable from OpCo	-	150
Investment in OpCo	200	90
Net assets	200	240
Share capital	50	50
Merger reserve	150	40
Retained profits	-	150
Total equity	200	240

If HoldCo does take advantage of merger relief, then the merger reserve is available to offset the impairment of the investment in OpCo in accordance with Part 6 of the new CO. So in this example, $110,000 of that reserve can be regarded as realized. This has been reflected above by transferring this amount from the merger reserve to retained profits.

In this way, pre-acquisition distributable profits of OpCo (the subsidiary) paid up as dividends to HoldCo (the new parent) are still available for onward distribution by the parent under the Part 6 distributable profits regime.

To summarise: comparing Example 3.1 with Example 3.2, it can be seen that the application of HKAS 27.13 has the following effects:

- the carrying value of the investment in the new subsidiary will generally be lower under HKAS 27.13 than a full fair value model;
- as a consequence, impairment losses booked on that investment, for example when pre-acquisition dividends are paid up by the subsidiary, may be lower; but
- provided that the parent takes advantage of merger relief when the subsidiary is acquired, this different income statement outcome makes no difference to the amount of distributable profits computed under Part 6 of the new CO, as the merger reserve created by that relief can be regarded as realized to the extent that a subsequent impairment loss related to the acquired subsidiary has been recognised.

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Group reconstruction relief

What is group reconstruction relief?

- *New CO s195 compared to old CO s48D*

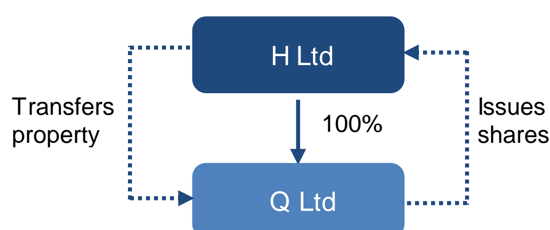
Similar to merger relief, "group reconstruction relief" is the relief from recording part of the consideration received in share capital. It is given under both the old and the new CO if a wholly-owned subsidiary issues its own equity shares as consideration for the transfer of non-cash assets from the company's holding company or any of the holding company's wholly-owned subsidiaries. From an accounting perspective the relief is reflected in the company-level financial statements.

As with merger relief, group reconstruction relief is important because of the restrictions on making distributions out of share capital. By giving relief from recording amounts in share capital it prevents "dividend traps" arising in the share-issuing company, which are when distributable profits are blocked from onward distribution at this company's level. In the case of a group reconstruction this would be when the transferred asset, such as a property, has a fair value in excess of its current carrying value.

Example 3.3 – Group reconstruction relief

Q Ltd is a wholly owned subsidiary of H Ltd. On 31 December 2014, Q Ltd issues 1,000 of its own equity shares to H Ltd in exchange for a property owned by H Ltd. The property is a factory used by H Ltd for the group's manufacturing operations and is carried at its depreciated cost of $5m. A recent appraisal of the property estimated its current market value is $15m.

The group structure and the transaction are as follows:



Q Ltd's statement of financial position immediately before and after the transaction is as follows:

	Before	After, with relief[1]	After, without relief[1]
	$'m	$'m	$'m
Sundry net assets	50	50	50
Factory building[2]	-	5	15
Net assets	50	55	65
Share capital[1]	10	15	25
Retained profits	40	40	40
Total equity	50	55	65

Note 1: *Group reconstruction relief is optional – at the time of acquiring the factory Q Ltd can choose whether or not to take advantage of the relief:*

- *If Q Ltd takes advantage of the relief then Q Ltd's share capital only needs to increase by the "base value" of the assets acquired. In this example, this would be $5m (i.e. the carrying value of property in H Ltd's accounting records immediately prior to the transfer). "Base value" is defined in section 195(4) of the new CO as the lesser of (a) the cost of the assets to the transferor company (here H Ltd) and (b) the amount at which those assets are stated in the transferor company's accounting records immediately prior to transfer.*
- *If Q Ltd does not take advantage of the relief then Q Ltd's share capital increases by the full amount of the consideration for the shares issued i.e. it increases by $15m from $10m to $25m. Note that the decision to take the relief must be made at the time when the shares are issued. The issuer cannot decide retrospectively to take the relief in a later year.*

Note 2: *As this is a transaction between entities under common control, in our view it is acceptable to adopt a policy of using book values. Alternatively, if fair value is used when group reconstruction relief is taken, then a capital reserve would be created in Q Ltd's financial statements to hold the difference in equity in a similar way to that illustrated in Example 3.1.*

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What happens if Q Ltd sells the factory to a third party …

The purpose of group reconstruction relief is to prevent unrealized profits earned within a wholly-owned group being locked into share capital. This can be seen if we look at what would happen if Q Ltd were to sell the factory to a third party for its appraised value of $15m.

Q Ltd's statement of financial position immediately before and after this second transaction would be as follows:

	With group reconstruction relief		Without group reconstruction relief	
	Before $'m	After $'m	Before $'m	After $'m
Sundry net assets	50	65	50	65
Factory building	5	-	15	-
Net assets	55	65	65	65
Share capital	15	15	25	25
Retained profits	40	50	40	40
Total equity	55	65	65	65

As a result of taking group reconstruction relief when it issued shares, Q Ltd is able to record a distributable profit of $10m when it sells the factory to the third party for $15m, and can distribute this to H Ltd (as Q Ltd does not have any accumulated losses). This is the same profit that H Ltd would have recorded if it had sold the property itself to third parties.

If Q Ltd had not taken group reconstruction relief when the shares were issued, then this profit is effectively capitalised into Q Ltd's share capital and cannot be distributed as a dividend to H Ltd. The only way for Q Ltd to return it to H Ltd would be to go through the procedures for a capital reduction as discussed in Appendix 1.

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