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Amendments to HKFRSs
Is acquisition of investment property(ies) in a company an asset acquisition or a business combination?

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Authors: Candy Fong and William Lim

Background

The Hong Kong Institute of Certified Public Accountants (HKICPA) will *shortly* issue *Annual Improvements to HKFRSs 2011 – 2013 Cycle*, which are identical to the amendments to IFRSs issued by the International Accounting Standards Board in December 2013. The amendments to HKFRSs are expected to be issued later in January 2014.

These Annual Improvements contain amendments to 4 Standards, one of which relates to the commonly encountered issue as to whether an acquisition of a company whose principal assets are investment properties should be treated as an acquisition of assets or a business combination. The amendment to HKAS 40 *Investment Property* requires that reference should be made to HKFRS 3 *Business Combinations* when determining whether or not the acquisition of an investment property is a business combination. The amendment makes it clear that, despite the fact that an acquired property meets the definition of an investment property in accordance with HKAS 40, assessment should be performed as to whether the acquisition is an asset acquisition or a business combination in accordance with HKFRS 3.

The amendment to HKAS 40 will become mandatorily effective for annual periods beginning on or after 1 July 2014. This amendment may have significant impact, particularly on companies who used to believe that an acquisition of a single-asset company whose principal asset is an investment property(ies) must be treated as an asset acquisition and hence there is no need to consider HKFRS 3. The accounting treatments for an acquisition of asset(s) and a business combination are very different; the key differences are set out in the table below.

	Acquisition of asset(s)	**Business combination**
What is the applicable standard?	Various HKFRSs (e.g. HKAS 40, HKAS 16 *Property, Plant and Equipment*, HKAS 2 *Inventories*) HKFRS 3.2(b) scopes out acquisition of an asset or a group of assets that does not constitute a business from HKFRS 3.	HKFRS 3
How to account for the consideration for the acquisition?	Consideration paid and payable would be allocated among the assets acquired.	Both consideration paid and payable as well as assets acquired have to be measured at fair value at the date of business combination.
How to account for the transaction costs?	Follow the applicable HKFRSs (e.g. HKAS 40, HKAS 16 and HKAS 2). For example, HKAS 2, HKAS 16 and HKAS 40 require properties to be initially measured at cost which generally include directly attributable transaction costs.	HKFRS 3 generally requires transaction costs to be expensed in profit or loss immediately.
Would the acquisition give rise to any goodwill/bargain purchase?	No	Any excess of the consideration over the recognised net assets of the acquiree should be recognised as goodwill. Annual impairment assessment on goodwill is required. Any excess of the recognised net assets of the acquiree over the consideration should be recognised in profit or loss as a bargain purchase (after reassessment).
Is there any additional deferred tax to be recognised at the date of the acquisition?	No. HKAS 12.15 prohibits the recognition of a deferred tax liability for taxable temporary difference if it arises from the initial recognition of an asset in a transaction which is not a business combination and does not affect either accounting profit or taxable profit at the time of the transaction.	Yes, deferred tax liabilities should be recognised at the date of business combination in relation to fair value adjustments made at the date of business combination.

What are the requirements in HKFRS 3 with regard to the determination of whether an acquisition is an asset acquisition or a business combination?

The above amendment requires that the assessment of whether an acquisition of an asset or a group of assets is an asset acquisition or a business combination should be made by reference to HKFRS 3. No further guidance is provided in the amendment. Entities should refer to the *existing* guidance in HKFRS 3 as to what constitutes a business.

HKFRS 3 defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members and participants. Specifically, the Standard states that a business consists of inputs and processes that have the ability to create outputs. Definitions of inputs, processes and outputs are as follows: [HKFRS 3.B7]

- An input is defined as any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it (e.g. intangible assets, intellectual property, the ability to obtain access to necessary materials or rights and employees).
- A process is defined as any system, standard, protocol, convention or rule that when applied to an input or inputs, creates or has the ability to create outputs (e.g. strategic management processes, operational processes and resource management process). These processes typically are documented, but an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.
- An output is the result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

To qualify for the definition of a business, the integrated set of activities and assets should have 2 essential elements – inputs and processes. [HKFRS 3.B8] Outputs are not necessarily required (although businesses usually have outputs). [HKFRS 3.B7]

Also, the Standard requires the assessment as to whether an integrated set of businesses and assets meets the definition of a business to be made from a market participant's perspective. An integrated set of activities and assets need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes. [HKFRS 3.B8]

The Standard acknowledges that the nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. [HKFRS 3.B9] For example, established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single input (product). [HKFRS 3.B9] Also, an integrated set of assets and activities that is in the development stage might not have outputs. Other factors (including but are not limited to) should be considered: [HKFRS 3.B10]

- The set of activities has begun planned principal activities;
- The set of activities has employees, intellectual properties and other inputs and processes that could be applied to inputs;
- The set is pursuing a plan to produce outputs; and
- The set will be able to obtain access to customers that will purchase the outputs.

The Standard also states that nearly all businesses also have liabilities, but a business need not have liabilities. [HKFRS 3.B9]

Practical examples on how to apply the requirements of HKFRS 3

To apply the above requirements, *judgement* is required taking into account the specific facts and circumstances.

Below are examples.

Example 1	
Facts and circumstances	**Application of the requirements of HKFRS 3**
On 1 January 20X1, Company A acquired 100% equity interest of Company E, a shell company that owns a commercial property in Country E. The property meets the definition of an investment property in accordance with HKAS 40 as the property would be used by Company A to earn rental income or for capital appreciation purpose. After the acquisition, Company A will use its own property management team to manage the commercial property acquired. From Company E's perspective, it has a deferred tax liability that reflects taxable temporary difference in relation to the commercial property. Company A is a property holding company which indirectly owns, inter alia, a number of investment properties through shell companies, as follows: Company A Company B / Company C / Company D Investment property B / Investment property C / Investment property D	The asset acquired is just a commercial property which in itself does not meet the definition of a business. As mentioned above, HKFRS 3 requires a set of assets and activities to have 2 essential elements (which are inputs and processes) in order for the set to meet the definition of a business. There are no 'processes' in this Example. Therefore, Company A should account for the acquisition as an asset acquisition in accordance with HKAS 40 – Company A should record the acquired commercial property at the amount of the consideration paid and payable. Any directly attributable transaction costs should be capitalised as part of the cost of the property. The deferred tax liability recognised by Company E in its own financial statements in respect of taxable temporary difference that arose before the acquisition should be reversed by Company A in its consolidated financial statements as a permanent consolidation adjustment. This is because HKAS 12.15 prohibits the recognition of a deferred tax liability for taxable temporary difference if it arises from the initial recognition of an asset in a transaction which is not a business combination and does not affect either accounting profit or taxable profit at the time of the transaction.

Example 2	
Facts and circumstances	**Application of the requirements of HKFRS 3**
On 1 January 20X1, Company A acquired 100% equity interest of Company B that owns a number of commercial properties. Company B has a property management team who manages the property portfolio (including handling tenancy agreement negotiations and related matters, and provision of other property management services to tenants). The property management team of Company B will continue to manage the portfolio. From Company B's perspective, the tax base of the commercial properties as at 1 January 20X1 amounts to CU 20 million. The consideration for the acquisition amounts to CU 100 million. The fair value of the properties as at 1 January 20X1 amounts to CU 120 million. Transaction costs in relation to this acquisition amounts to CU 5 million. The applicable tax rate is 20% (assume the same tax rate applies regardless whether the sale presumption is rebutted for deferred taxation purposes).	In this Example, what are acquired by Company A are not just properties but also the property management team which is an essential process for the purpose of creating outputs. Since the set of assets and activities include inputs (i.e. properties) and processes (i.e. the property management team) that are capable of producing outputs (rental income and capital appreciation gains), the acquisition is a business combination in accordance with HKFRS 3 and hence should be accounted for as such in accordance with HKFRS 3. Specifically, Company A should take the following steps: a) Determine the amount of consideration for the business combination (which is equal to CU 100 million). b) Determine the fair value of the acquired commercial properties (which is equal to CU 120 million). c) Recognise deferred tax liabilities on the fair value adjustment of the properties acquired (which is equal to CU 20 million ((CU 120 million – CU20 million)*20%)). d) Calculate the amount of goodwill or bargain purchase. No goodwill or bargain purchase will be recognised (CU 100 million – (CU 120 million – CU 20 million)). e) Expense the transaction costs of CU 5 million in profit or loss immediately. In contrast, if the acquisition had been *wrongly* concluded as an acquisition of assets rather than a business combination, Company A would recognise the properties at CU 105 million on initial recognition (CU 100 million that represents the consideration plus CU 5 million that represents the directly attributable transaction costs) and no deferred tax liabilities would have been recognised at initial recognition.

Example 3	
Facts and circumstances	**Application of the requirements of HKFRS 3**
On 1 January 20X1, Company A acquired 100% equity interest of Company B that owns a property under development (principally a piece of land with foundation work done). Company B also has a secured bank borrowing with the piece of land owned by Company B being pledged as collateral. Company A is a property developer. After the acquisition, Company A will continue to develop the property as residential property for sale purpose. Company B does not have any employees to complete the development project as the project team members were employees of the Seller.	The acquiree has a bank borrowing and other construction payables. However, the existence of liabilities in itself does not support that there is a business. HKFRS 3 requires the existence of inputs and processes that are capable of creating outputs. The property under development in itself (without any acquired project team) does not fulfill the 'processes' requirement. Although HKFRS 3 does say that an integrated set of activities and assets need not include *all* of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, the acquired items contain no processes at all. Therefore, Company A should account for the acquisition as an asset acquisition in accordance with HKAS 2 – Company A should record the acquired property under development at the amount of the consideration paid and payable. Any directly attributable transaction costs should be capitalised as part of the cost of the property under development.

Example 4	
Facts and circumstances	**Application of the requirements of HKFRS 3**
Same facts as Example 3 except that Company B has its own project team (that includes main civil engineers and designers) handling the development of the project. After the acquisition, Company A will enter into a new contractor contract with one of its long-established contractors to do the construction work. In Company B's financial statements, the property under development is recorded at cost and the carrying amount of the property under development as at 1 January 20X1 amount to CU 20 million (the tax base is also equal to CU 20 million). The consideration for the acquisition amounts to CU 100 million that reflects the fair value of the property under development as at 1 January 20X1. Transaction costs in relation to this acquisition amounts to CU 5 million. The applicable tax rate is 20%.	Unlike Example 3, Example 4 does include some essential 'processes' (although not all 'processes') – Company B has its own project management team to handle the development of the project. The fact that Company A can choose the contractors to complete the construction work demonstrates that Company A has control over Company B after the acquisition – this fact does not negate that the set of assets and activities acquired is a business. Company A should account for the acquisition as a business combination in accordance with HKFRS 3. Specifically, Company A should take the following steps: a) Determine the amount of consideration for the business combination (which is equal to CU 100 million). b) Determine the fair value of the acquired property under development (which is equal to CU 100 million). c) Recognise deferred tax liabilities on the fair value adjustment of the properties acquired (which is equal to CU 16 million ((CU 100 million – CU20 million)*20%). d) Calculate the amount of goodwill or bargain purchase. Goodwill of CU 16 million should be recognised (CU 100 million – (CU 100 million – CU 16 million)). Goodwill should be tested for impairment annually irrespective of whether there is any impairment indicator. e) Expense the transaction costs of CU 5 million in profit or loss immediately.

Effective date and transitional provision

An entity should apply the amendments for annual periods beginning on or after 1 July 2014. Earlier application is permitted, with the statement of fact of early application being disclosed in the notes to the financial statements.

The amendment requires prospective application to be applied to acquisitions that take place from the beginning of the first period for which the amendment is adopted. For example, if a December-year-end entity adopts the amendment for the first time for the year ending 31 December 2015, the amendment is required to be applied to acquisitions that take place on or after 1 January 2015 – comparative figures should not be adjusted.

However, an entity may choose to apply the amendments to individual acquisitions of investment property that occurred prior to the beginning of the first annual period occurring on or after the effective date if, and only if, information needed to apply the amendment to those earlier transactions is available to the entity.

35/F One Pacific Place
88 Queensway
Hong Kong

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