Questions and Answers relating to court-free amalgamation

These Q&As have been developed by the HKICPA's Companies Ordinance Project Advisory Panel and are endorsed by the HKICPA's Financial Reporting Standards Committee (FRSC). These Q&As will be updated from time to time to provide references on financial reporting related application issues pertaining to the Hong Kong Companies Ordinance Cap. 622.

These Q&As are non-mandatory in nature and intended for general reference only. Users of these Q&As should consider taking their own legal advice if in doubt as to their obligations under the Hong Kong Companies Ordinance.

All references to Parts, Divisions, Sub-divisions, Schedules and sections in the questions and answers are to the CO Cap. 622, unless otherwise indicated.

Question 1
Sections 678 to 686 of the CO Cap. 622 allow two or more companies to be amalgamated into a single legal entity without involving the court ("court-free amalgamation") in the following cases:

(a) A holding company may amalgamate with one or more of its wholly owned subsidiaries (a vertical amalgamation) and continue as one company (amalgamated company).
(b) Two or more wholly-owned subsidiaries of a holding company may amalgamate (a horizontal amalgamation) and continue as one company (amalgamated company).

In a vertical amalgamation, the shares of each of the amalgamating subsidiaries will be cancelled (section 680). In a horizontal amalgamation, the shares of all but one of the amalgamating companies will be cancelled (section 681) only leaving in issue the shares of the amalgamated company. Section 678(2) of the CO Cap. 622 states that “A cancellation of shares under this Division is not a reduction of share capital for the purposes of Part 5.”

What would be the share capital of the amalgamated company after the amalgamation?

Answer
The Companies Registry’s FAQ confirms that there is no requirement under Division 3 of Part 13 of the CO Cap. 622 for an amalgamated company to increase its share capital upon amalgamation. In other words the CO Cap. 622 does not require the amalgamated company to increase the amount of its share capital by the amount of the share capital of the amalgamating companies whose shares are cancelled and which cease to exist as entities separate from the amalgamated company. Therefore, the share capital of the amalgamated company will be the amount of share capital of the company whose shares are not cancelled.

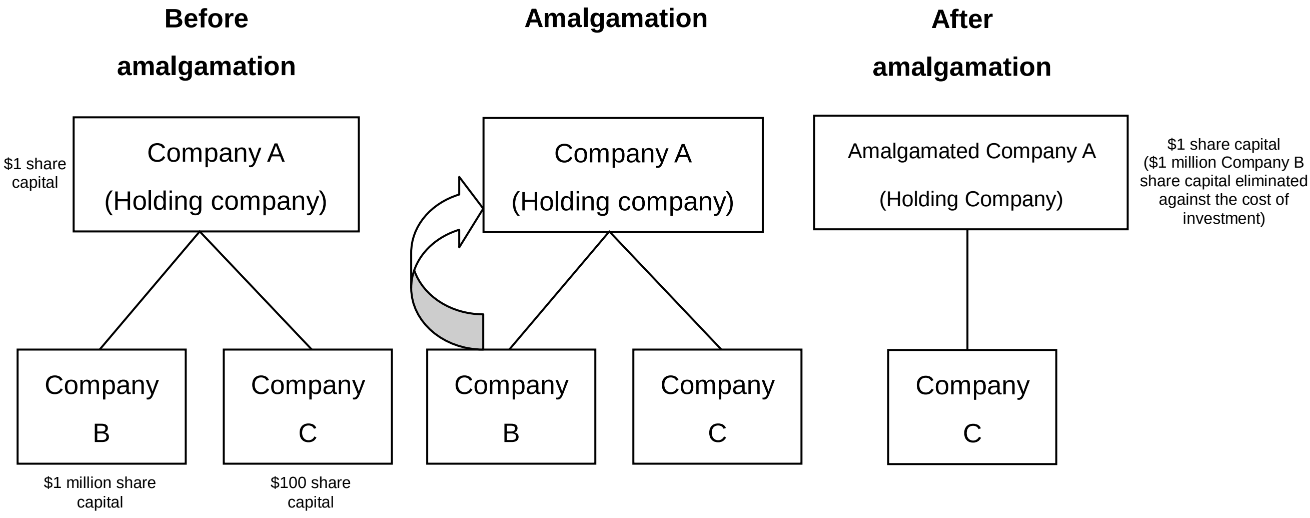
If the amalgamated company chooses to increase its share capital above this amount by, for example, capitalizing any of the reserves that have arisen as a result of the amalgamation, then this should be regarded as an increase in accordance with section 170(2)(c) and therefore the notification and filing requirements of section 171 apply.

If the amalgamated company does not choose to increase its share capital then the impact of the amalgamation on the amalgamated company’s statement of financial position is illustrated in the following examples:

Vertical Amalgamation

Using example 1 below, assume Company A wholly owns two subsidiaries, Company B and Company C, since the date that these subsidiaries were incorporated. Company A decides to amalgamate with Company B and continue as one company. Before amalgamation, Company A has $1 share capital and Company B has $1 million share capital. Upon amalgamation[1], the share capital of the amalgamated company is $1, as the $1 million Company B share capital is eliminated against the cost of investment in Company B which was previously recorded in Company A's statement of financial position. Company B ceases to exist as an entity separate from the amalgamated Company A and its shares are cancelled.

Example 1



(i) Before amalgamation: Consolidation

	Holding company A $	Subsidiary company B $	Subsidiary company C $	Consolidation adjustments $	Consolidated group $
Investment in subsidiaries	1,000,100	-	-	(1,000,100)	-
Other net assets	800,000	1,200,000	50,000		2,050,000
Total net assets	**1,800,100**	**1,200,000**	**50,000**	**(1,000,100)**	**2,050,000**
Share capital	1	1,000,000	100	(1,000,100)	1
Retained earnings	1,800,099	200,000	49,900		2,049,999
Total equity	**1,800,100**	**1,200,000**	**50,000**	**(1,000,100)**	**2,050,000**

1 In accordance with section 685(3)(c) of the CO Cap. 622, on the effective date of an amalgamation, the amalgamated company succeeds to all the property, rights and privileges, and all the liabilities and obligations, of each amalgamating company. Consequently, the net assets of each of the amalgamating company or companies as at the effective date of amalgamation will be included in the amalgamated company's statement of financial position.

To achieve the amalgamation, Company A needs to make the same journal entries into its own books to absorb B as it would have done on consolidation immediately prior to the amalgamation. As court-free amalgamation is a new concept for Hong Kong, there is no specific accounting guidance. However, as all court-free amalgamations can only occur within wholly-owned groups under the CO Cap. 622, the most relevant guidance is found in Accounting Guideline 5 *Merger Accounting for Common Control Combinations* issued by the HKICPA. 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 of these entities first occurred. This includes bringing in all assets and liabilities at their carrying amounts in the previous financial statements and restating the comparative amounts to include the combined history of the entities. This can be seen from the following amalgamation workings:

(ii) Amalgamation: Workings

	Before amalgamation:			**After amalgamation:**
	Holding company A $	**Subsidiary company B $**	**Amalgamation adjustments $**	**Amalgamated holding company A $**
Investment in subsidiaries	1,000,100	-	(1,000,000)	100
Other net assets	800,000	1,200,000		2,000,000
Total net assets	**1,800,100**	**1,200,000**	**(1,000,000)**	**2,000,100**
Share capital	1	1,000,000	(1,000,000)	1
Retained earnings	1,800,099	200,000		2,000,099
Total equity	**1,800,100**	**1,200,000**	**(1,000,000)**	**2,000,100**

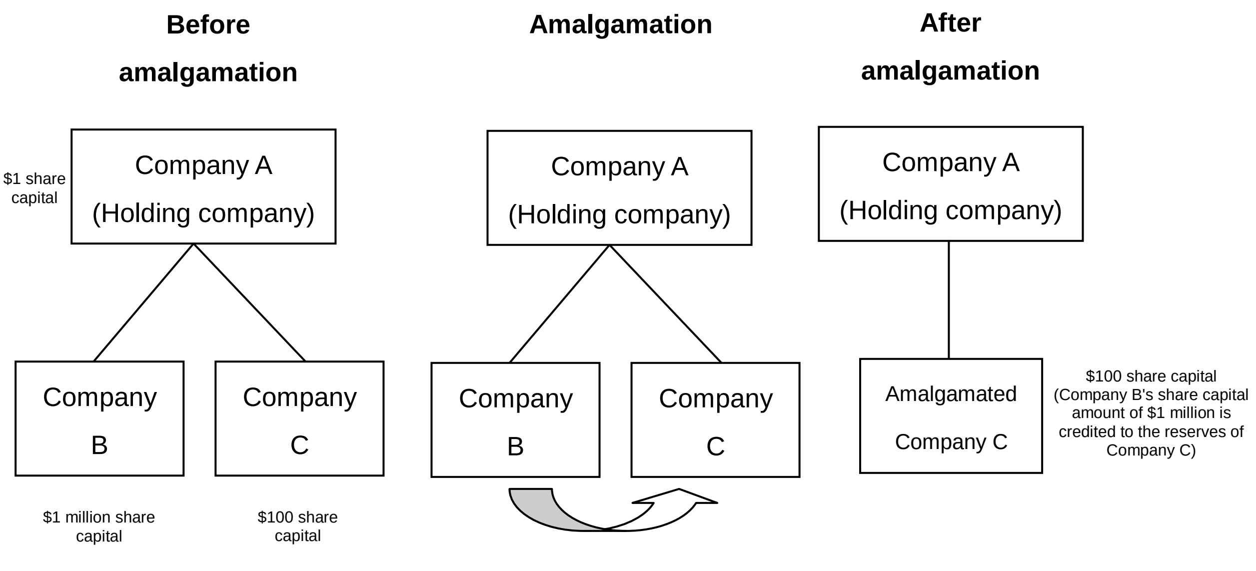
(iii) After amalgamation: Consolidation

	Amalgamated holding company A $	**Subsidiary company C $**	**Consolidation adjustments $**	**Consolidated group $**
Investment in subsidiary	100	-	(100)	-
Other net assets	2,000,000	50,000		2,050,000
Total net assets	**2,000,100**	**50,000**	**(100)**	**2,050,000**
Share capital	1	100	(100)	1
Retained earnings	2,000,099	49,900		2,049,999
Total equity	**2,000,100**	**50,000**	**(100)**	**2,050,000**

Horizontal Amalgamation

Using the same facts as in example 1, assume that instead of a vertical amalgamation, Companies B and C decide to amalgamate horizontally, where the shares of Company B will be cancelled and the shares of Company C will not be cancelled. Before the amalgamation, Company B has $1 million share capital and Company C has $100 share capital. Upon amalgamation[2], the share capital of the amalgamated company is $100, as the shares of Company B are cancelled. The $1 million Company B share capital is credited to the reserves of the amalgamated Company C which represents a capital contribution from Company A as the amalgamated Company C receives the net assets of Company B for nil consideration. From the effective date of amalgamation, Company B ceases to exist as an entity separate from the amalgamated Company C.

Example 2



(i) Before amalgamation: Consolidation

	Holding company A $	Subsidiary company B $	Subsidiary company C $	Consolidation adjustments $	Consolidated group $
Investment in subsidiaries	1,000,100	-	-	(1,000,100)	-
Other net assets	800,000	1,200,000	50,000		2,050,000
Total net assets	**1,800,100**	**1,200,000**	**50,000**	**(1,000,100)**	**2,050,000**
Share capital	1	1,000,000	100	(1,000,100)	1
Retained earnings	1,800,099	200,000	49,900		2,049,999
Total equity	**1,800,100**	**1,200,000**	**50,000**	**(1,000,100)**	**2,050,000**

2 In accordance with section 685(3)(c) of the CO Cap. 622, on the effective date of an amalgamation, the amalgamated company succeeds to all the property, rights and privileges, and all the liabilities and obligations, of each amalgamating company. Consequently, the net assets of each of the amalgamating company or companies as at the effective date of amalgamation will be included in the amalgamated company's statement of financial position.

To achieve the amalgamation, Company C needs to make the journal entries into its own books to absorb the net assets of B. This can be seen from the following amalgamation workings:

(ii) Amalgamation: Workings

	Before amalgamation:			**After amalgamation:**
	Subsidiary company B $	**Subsidiary company C $**	**Amalgamation adjustments $**	**Amalgamated subsidiary company C $**
Investment in subsidiaries	-	-		-
Other net assets	1,200,000	50,000		1,250,000
Total net assets	**1,200,000**	**50,000**		**1,250,000**
Share capital	1,000,000	100	(1,000,000)	100
Other reserves	-	-	1,000,000	1,000,000
Retained earnings	200,000	49,900		249,900
Total equity	**1,200,000**	**50,000**		**1,250,000**

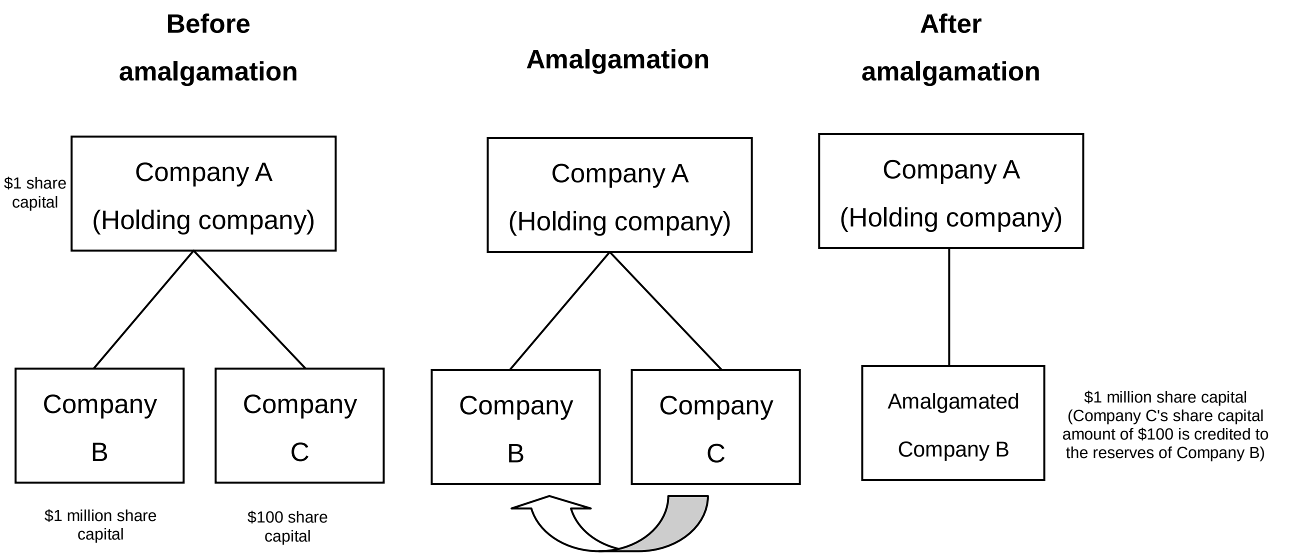
(iii) After amalgamation: Consolidation

	Holding company A $	**Amalgamated subsidiary company C $**	**Consolidation adjustments $**	**Consolidated group $**
Investment in subsidiary	1,000,100	-	(1,000,100)	-
Other net assets	800,000	1,250,000		2,050,000
Total net assets	**1,800,100**	**1,250,000**	**(1,000,100)**	**2,050,000**
Share capital	1	100	(100)	1
Other reserves	-	1,000,000	(1,000,000)	-
Retained earnings	1,800,099	249,900		2,049,999
Total equity	**1,800,100**	**1,250,000**	**(1,000,100)**	**2,050,000**

Extended Question 1 (modified): What if the shares of Company C, instead of Company B, will be cancelled in the horizontal amalgamation?

Example 2 above shows the impact on the financial statements if Company B's shares will be cancelled in a horizontal amalgamation with Company C. If instead Company C's shares are cancelled (i.e. Company B's shares are not cancelled) and, consequently, Company C ceases to exist as an entity separate from the amalgamated Company B, the amalgamation workings would be the same as example 2 but the results would be different. Example 3 below illustrate the amalgamation workings if Company C's shares are cancelled as follows:

Example 3



(i) Amalgamation: Workings

	Before amalgamation: Subsidiary company B $	**Before amalgamation: Subsidiary company C $**	**Amalgamation adjustments $**	**After amalgamation: Amalgamated subsidiary company B $**
Investment in subsidiaries	-	-		-
Other net assets	1,200,000	50,000		1,250,000
Total net assets	**1,200,000**	**50,000**		**1,250,000**
Share capital	1,000,000	100	(100)	1,000,000
Other reserves	-	-	100	100
Retained earnings	200,000	49,900		249,900
Total equity	**1,200,000**	**50,000**		**1,250,000**

(ii) After amalgamation: Consolidation

	Holding company A $	Amalgamated subsidiary company B $	Consolidation adjustments $	Consolidated group $
Investment in subsidiary	1,000,100	-	(1,000,100)	-
Other net assets	800,000	1,250,000		2,050,000
Total net assets	**1,800,100**	**1,250,000**	**(1,000,100)**	**2,050,000**
Share capital	1	1,000,000	(1,000,000)	1
Other reserves	-	100	(100)	-
Retained earnings	1,800,099	249,900		2,049,999
Total equity	**1,800,100**	**1,250,000**	**(1,000,100)**	**2,050,000**

Question 2
In a horizontal amalgamation, the share capital of each of the amalgamating company or companies whose shares are cancelled and which cease to exist as separate entities after the amalgamation is recorded in a reserve in shareholders' funds outside share capital of the amalgamated company. Is this reserve, arising from amalgamation, available for distribution?

Answer
Per section 678(2) of the CO Cap. 622, a cancellation of shares under Division 3 of Part 13 of the CO Cap. 622 is not a reduction of share capital for the purposes of Part 5. As a result, section 214(1) of Part 5[3] (Transactions in relation to Share Capital) of the CO Cap. 622 does not apply to amalgamations under Division 3 of Part 13. Instead, the general principles of Part 6 of the CO Cap. 622 (Distribution of Profits and Assets) apply when determining whether a reserve arising from cancellation of shares under Division 3 of Part 13 or court-free amalgamation can be regarded as realised profit and therefore available for distribution.

For example, if the share capital amount of an amalgamating company whose shares are cancelled was originally recorded on the issue of shares for cash, then the amount of reserve in the amalgamated company's statement of financial position after amalgamation, which is derived from that original transaction, would be regarded as realised. In example 2 this would mean that $1,000,000 would be available for distribution, whereas in example 3 the amount is only $100, assuming in each case that the share capital was originally contributed in the form of cash or other qualifying forms of consideration.

However, if the amalgamating company's share capital amount originated from the issue of shares for a non-cash asset, which continues to be held by the amalgamated company after the amalgamation, then the amount of the reserve attributable to the amalgamating company's share capital will not be regarded as realised until that non-cash asset is impaired, depreciated or disposed of for qualifying consideration.

3 Section 214(1) states that "If a company reduces its share capital in accordance with this Division, a reserve arising from the reduction is to be regarded for the purposes of Part 6 as realized profit"

More guidance on forms of qualifying consideration and determining whether a profit is realised or unrealised can be found in Accounting Bulletin 4 issued by the HKICPA.

Question 3
In a horizontal amalgamation should the original retained earnings of each of the amalgamating company or companies, whose shares are cancelled and which cease to exist as separate entities after the amalgamation, continue to be a source of profits available for distribution?

Answer
In a horizontal amalgamation, the original retained earnings of the amalgamating company or companies, whose shares are cancelled, continue to be a source of realised profit under Part 6, to the extent the amount of the retained earnings were realised prior to amalgamation.

However, as a reminder, distributable reserves are assessed on a collective basis at the company level. If one of the amalgamating companies had accumulated realised losses at the date of the amalgamation, and the other amalgamating company had accumulated realised profits at that date, then the distributable reserves of the amalgamated company would need to be computed on a net basis. This is in accordance with section 297 of the CO Cap. 622.

For example, Companies F and G are fellow subsidiaries and decide to amalgamate. Company F's shares are not cancelled and Company G ceases to exist as an entity separate from the amalgamated Company F. At the time of the amalgamation, Company F had retained earnings of $50,000, all of which were realised and Company G had accumulated losses of $20,000, all of which were realised. On the effective date of the amalgamation, the distributable reserves of the amalgamated Company F will be only $30,000 plus any amount of the “other reserve” arising from the amalgamation, which is distributable per the answer to question 2 above.

More guidance on determining whether a profit is realised or unrealised can be found in Accounting Bulletin 4 issued by the HKICPA.

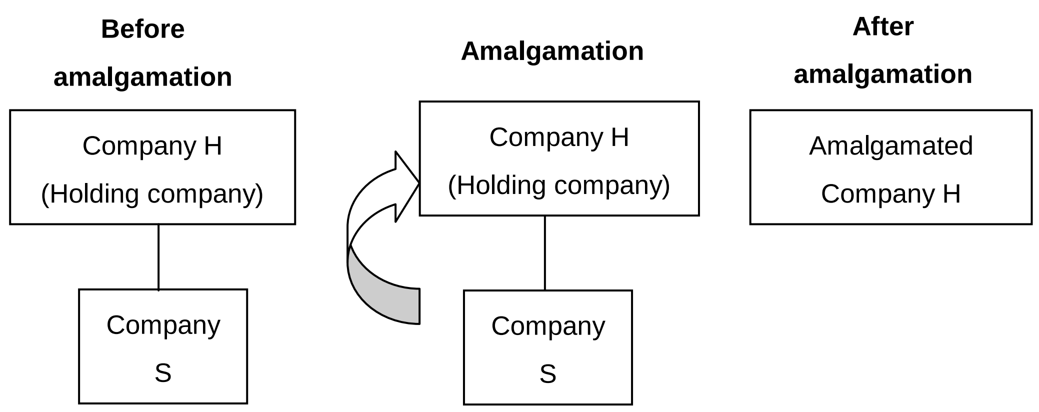
Question 4
Does the answer to question 3 also apply to a vertical amalgamation?

Answer
In a vertical amalgamation, the answer depends on whether at the time of the amalgamation the reserves were pre-acquisition reserves or post-acquisition reserves.

Pre-acquisition reserves of a subsidiary are reserves that are eliminated against the cost of investment whenever the holding company prepares consolidated financial statements, which include the wholly owned subsidiary. Post-acquisition reserves of a subsidiary are those reserves which are not eliminated on consolidation.

The answer to question 3 applies only in respect of post-acquisition reserves in a vertical amalgamation. Any pre-acquisition reserves will be eliminated as part of the journals to be made at the time of the amalgamation to eliminate the cost of investment. This is illustrated in the following example:

Example 4



Company H acquired 100% of Company S's shares three years ago for a consideration of $1,000,000. At the date of acquisition Company S's statement of financial position was as follows:

	Company S $
Total net assets (at fair value)	**800,000**
Share capital	1,000
Retained earnings	799,000
Total equity	**800,000**

For the purpose of this illustration the fair values and book amounts of Company S's identifiable assets and its liabilities are assumed to be the same. Consequently, the consolidation journal to reflect the acquisition of subsidiary Company S into Company H's consolidated financial statements at the date of acquisition is as follows:

(i) Before Amalgamation: Consolidation immediately after acquiring Company S

	Holding company H $	Subsidiary company S $	Consolidation adjustments $	Consolidated group $
Investment in subsidiary	1,000,000	-	(1,000,000)	-
Goodwill	-	-	200,000	200,000
Other net assets	2,000,000	800,000		2,800,000
Total net assets	**3,000,000**	**800,000**	**(800,000)**	**3,000,000**
Share capital	100,000	1,000	(1,000)	100,000
Retained earnings	2,900,000	799,000	(799,000)	2,900,000
Total equity	**3,000,000**	**800,000**	**(800,000)**	**3,000,000**

In the three years since acquisition, subsidiary Company S accumulated $300,000 of retained profits (all of which were realised for the purpose of this illustration); none of which were distributed to Company H.

Company H decides to vertically amalgamate with subsidiary Company S. Immediately prior to the amalgamation the financial position of the group was as follows:

(ii) Before amalgamation: Consolidation three years after acquisition

	Holding company H $	**Subsidiary company S $**	**Consolidation adjustments $**	**Consolidated group $**
Investment in subsidiary	1,000,000	-	(1,000,000)	-
Goodwill	-	-	200,000	200,000
Other net assets	2,000,000	1,100,000		3,100,000
Total net assets	**3,000,000**	**1,100,000**	**(800,000)**	**3,300,000**
Share capital	100,000	1,000	(1,000)	100,000
Retained earnings	2,900,000	1,099,000	(799,000)	3,200,000
Total equity	**3,000,000**	**1,100,000**	**(800,000)**	**3,300,000**

To achieve the amalgamation, Company H needs to make the same journal entries into its own books to absorb subsidiary Company S as it would have done on consolidation immediately prior to the amalgamation. This can be seen from the following amalgamation workings:

(iii) Amalgamation: Workings

	Before amalgamation:			**After amalgamation:**
	Holding company H $	**Subsidiary company S $**	**Amalgamation adjustments $**	**Amalgamated company H $**
Investment in subsidiary	1,000,000	-	(1,000,000)	-
Goodwill	-	-	200,000	200,000
Other net assets	2,000,000	1,100,000		3,100,000
Total net assets	**3,000,000**	**1,100,000**	**(800,000)**	**3,300,000**
Share capital	100,000	1,000	(1,000)	100,000
Retained earnings	2,900,000	1,099,000	(799,000)	3,200,000
Total equity	**3,000,000**	**1,100,000**	**(800,000)**	**3,300,000**

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After the amalgamation, Company H no longer needs to prepare consolidated financial statements as it is no longer a holding company. The amounts in the last column of the table above ("After amalgamation: Amalgamated company H") are reported in amalgamated Company H's standalone financial statements, including the goodwill recognised on acquisition of Company S, as if it had acquired an unincorporated business. The realised profits of amalgamated Company H immediately after the amalgamation consist of the accumulated earnings of Company H ($2,900,000) and the post-acquisition accumulated earnings of Company S ($300,000) i.e. a net amount of $3,200,000[4] as shown above.

4 For the purposes of this illustration, it is assumed that all the retained earnings of Company H and the post-acquisition earnings of Company S are realised profits. In reality this may not be the case. Therefore, an analysis may be needed to determine the extent to which profits and losses within amalgamated Company H’s retained earnings are realised in accordance with the guidance in Accounting Bulletin 4 issued by the HKICPA.