Meeting with Business Combinations and Reporting Entity Advisory Panel
(via video-conference)

Date: 29 January 2021, Friday
Time: 2:00 pm – 5:00 pm

IASB Request for Information (RFI) – Post-implementation Review (PIR) of IFRS 10, 11 and 12

- Panel members noted that the objective of the meeting was to seek feedback from the Panel on the RFI.
- SSD staff provided an overview of the PIR, including the timeline of the project, and presented Panel members with details on each of the areas of focus in the RFI.

1. IFRS 10 Consolidated Financial Statements

a) Power over an investee – relevant activities

- Panel members generally considered that identification of relevant activities is not a significant issue after understanding the commercial rationale and business model of the investee, and agreed that the Standard is working as intended in this area.
- Panel members agreed that identifying the relevant activities involves significant judgement in complex situations. The following scenarios were shared by some Panel members.
  - The government is a shareholder of an entity (e.g. utilities or public transport company) and the price setting arrangement of the entity is regulated by the government. Questions arise as to whether price setting is a relevant activity of the entity, and whether the regulation of pricing by the government results from the government's acting in its capacity as a shareholder or as a regulatory body.
  - Two or more investors have control over different relevant activities at different times during the contractual period. For example, in a real estate company, one party controls the construction and the other party controls the sale of properties, or in a pharmaceutical company one party is responsible for research and development while another party is responsible for manufacturing and sales of a drug.
  - Different parties have different responsibilities in the arrangements. This is common among state-owned enterprises (SoE), franchise arrangements and just-in-time processing arrangements where one party determines the manufacturing decisions and the other party determines the selling decisions.
  - Special-purpose entities (SPE) are involved in the arrangement, e.g. in a pharmaceutical company, an investor owns the intellectual property of a drug while the clinical trials are carried out by a SPE. Questions may arise here regarding the interaction of economic activities of the SPE and the legal entity (i.e. unclear legal

boundaries in considering whether the SPE's activities should be taken into account as those of the legal entity in identification of relevant activities of the entity).

- Having said that, Panel members agreed that judgement is unavoidable in such cases, and the majority of the Panel members considered that the current requirements and application guidance are sufficient. A Panel member considered that additional guidance for complex areas could enhance consistent application of the Standard.
- A Panel member expressed the view that significant judgement is involved when there is an SPE, and sometimes management may exercise aggressive judgement in order to achieve intended accounting outcomes. However, this is more an audit/regulatory issue rather than the fault of IFRS 10.
- Another Panel member agreed with other members' views that no major issues were noted on the identification of relevant activities, but added that challenges exist in some cases when assessing who has the power over the investee.

b) Power over an investee – rights that give an investor power

- A Panel member shared his observations in practice that the meaning of certain items listed in IFRS 10.B23 to determine substantive rights are not very clear, e.g. financial penalties and incentives, and operational barriers, and this sometimes leads to inconsistent applications and outcomes. However, this Panel member acknowledged that the IASB may not be able to provide additional guidance on this area since the assessment of whether rights are substantive depends on the specific facts and circumstances.
- Two other Panel members considered that IFRS 10.B23 is helpful and not difficult to apply, though its application requires judgement.
- A Panel member considered the concepts of substantive rights and protective rights are useful, particularly for cases involving the exercise of options and potential voting rights.
- Another Panel member commented on the definition of protective rights. He referred to IFRS 10.B27, which states that protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate. This Panel member considered that all rights, including substantive rights, may be viewed as protecting the investors, and that in cases where an SPE is involved, the consideration of protective rights in the control assessment is usually very important. This Panel member questioned whether certain rights should always be classified as protective rights because the design/nature of the rights is such that those rights would not be considered substantive rights under IFRS 10 (i.e. rights designed to protect the investor rather than to give power to the investor). This issue has been discussed internally in his firm when the IFRS

Interpretation Committee issued the related agenda decision in September 2013[1] on when rights, previously determined to be protective, change. This Panel member noted that IFRS 10.13 states that an investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee. Accordingly, regardless of the types of rights, he considered all rights have to be considered in determining whether an investor has power over an investee under IFRS 10.13. In this Panel member's view, the current requirement to identify whether rights are protective rights is unnecessary. Hence, this Panel member suggested the IASB to consider (i) not to differentiate whether rights are protective rights, or (ii) to subordinate protective rights under IFRS 10.13 (rather than retain as a standalone concept), and to consider protective rights only when there are rights held by other parties that may restrict the power of the investor. The definition of protective rights could also be improved to reduce the time and judgement required (for an assessment that may often lead to the same conclusion as only applying IFRS 10.13).

- Two Panel members echoed that determining whether rights are substantive or protective is challenging when an SPE is involved. They shared that in the past, SPEs were used mainly in financial institutions (e.g. a financial institution lends money to a SPE), but they have become more pervasive in other industries. A Panel member further noted a situation where an SPE obtains loan financing where a lender (often a financial institution) has the rights to veto the investment decisions of the SPE. Such decisions could significantly change the credit risk of the SPE. According to IFRS 10.B28(a), a lender's right which restricts a borrower from undertaking activities that could significantly change the credit risk of the borrower is an example of protective right. The Panel member observed diversity in the market in determining whether such a veto right on investment decisions is a protective right (as similar rights are given to the lender for general money lending transactions) or a substantive right (as investment decisions are so significant to the returns of the SPE). Accordingly, this Panel member suggested the IASB to clarify the definition of protective rights particularly in similar scenarios.
- A Panel member shared her experience that to facilitate the power assessment, she identifies the contractual clauses that give rise to substantive rights and protective rights, and carries out a benefits analysis to assess the impact of those clauses on the investors' benefits.

[1] https://cdn.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ifrs-10-effect-of-protective-rights-on-an-assessment-of-control-september-2013.pdf

- A Panel member agreed with the principle in the Standard, but considered that it is difficult to apply. She noted that the Institute of Singapore Chartered Accountants issued guidance[2] on how to assess whether sponsors have control over the Real Estate Investment Trusts (REITs) in Singapore. This Panel member shared that whenever she came across REITs or similar structures, she made reference to the Singapore guidance. This publication highlights that when the government or the regulatory body requires specific structures or has certain 'super' rights, these rights may not be substantive. This member shared her major concern is whether those 'super' rights of a trustee or other supervisory bodies in this type of trust structure is protective or substantive. She also noted that many regulators, e.g. regulators in China, mandate certain requirements regarding roles of the trustee/supervisory body. In this case, questions arise as to whether those requirements would result in the rights becoming substantive, in which case the trust manager would have no power to control the trust (and would only be an agent or have joint control of the trust with the trustee/supervisory body). This Panel member also suggested that the HKICPA considers locally addressing common application issues in this area, as she did not think the IASB would resolve this.
- Another Panel member shared his view that the guidance in the Singapore publication noted above is controversial among his network firms; in particular, there are often different classes of rights in the trust and some of them could be ignored during the control assessment. It is difficult to comment on whether a conclusion is appropriate applying the Singapore guidance.
- A Panel member shared an application issue - when an entity undergoes an internal restructuring, how should one determine whether the protective rights would change to substantive rights. Another Panel member considered that a reassessment of control is required if there is a change in facts and circumstances. This Panel member added that it would be more challenging to assess when the change happens not due to a change in facts and circumstances, but rather solely because of the passage of time. However, such a situation is considered to be uncommon in practice.

c) Power over an investee – control without a majority of the voting rights

- Panel members generally agreed with the principles in the application guidance. However, they noted the principles are highly judgemental to apply, and more comprehensive examples to illustrate factors to be considered in a holistic assessment would be helpful. A

[2] https://www.isca.org.sg/docs/default-source/default-document-library/tech/consolidation-of-reits-final_3-dec-2013.pdf?sfvrsn=5a2654b3_0

Panel member added that whether additional illustrative examples are to be issued by the IASB or by the HKICPA could be further considered.

- A Panel member expressed the view that challenges in assessing de facto control arise regularly in Hong Kong and China, and complexity increases when SoEs are involved. Significant judgement is involved in a de facto control assessment and questions may arise as to whether that judgement is appropriate. Disclosures about the significant judgement and assumptions made in determining that an entity has de facto control would be important in these circumstances.
- Another Panel member echoed that de facto control assessments are common in Hong Kong and China, and are highly judgemental. IFRS 10.B46 is useful in this case as it explicitly states that if it is not clear, having considered the factors listed in IFRS 10.B42(a)-(d), that the investor has power, the investor does not control the investee.
- A Panel member noted that the Standard does not provide a minimum level of voting rights needed to achieve de facto control. However, Example 4 of IFRS 10.B43 illustrates that an investor with a 48% shareholding and a wide dispersion among remaining shareholdings (with no other individual holding more than 1%) has de facto control. This may imply that 48% is a benchmark. Questions arise then as to whether an investor holding less than 48% interest (e.g. 45% interest) in the investee could demonstrate the investor has de facto control.
- Two Panel members shared the following practical challenging situations in applying the application guidance of the Standard to carry out the de facto control assessment:
    - An investor has de facto control over an investee originally; however, the percentage of shareholding held by the investor decreases over time due to a dilution of shareholdings, and there are no other changes in facts and circumstances. The assessment becomes quantitative and highly judgemental for determining when the investor loses control over the investee.
    - An investor makes a new investment and concludes that there is no de facto control over the investee based on IFRS 10.B46 initially, because there is insufficient information to demonstrate it has de facto control over the investee at the time of purchase. Due to passage of time, more evidence arises to support that the investor has de facto control over the investee since the time of purchase. Some people questioned then whether the initial assessment and the conclusion that there is no de facto control is appropriate.

d) The link between power and returns – principals and agents

- A Panel member expressed her view that assessing the magnitude and variability in returns in determining whether it is an agent is challenging given that the Standard does not provide any specific threshold. For example, a general partner (GP) may only have small investment in a fund and limited variable returns, and one may conclude that the GP is an agent. However, as the sole investor delegates all its investment decision making power to the GP and the investor has limited rights related to investment decisions under a contractual arrangement, the investor seems to have no power. It is unclear from the application guidance in IFRS 10 whether the investor should consider the power of its delegate (i.e. the GP) when carrying out the assessment. This Panel member shared that in practice, the rights of the investor have to be clarified (e.g. whether the investor has kick-out rights) and thoroughly analysed to reach a conclusion, and this involves significant judgement.

- A Panel member also shared an example from the fund industry. At the inception of a fund, where there are only a few or no other limited partners (LP) or other investors, the fund manager and its group companies may invest seed money in the fund to initially establish it. The seed money investor would then be, at inception, the majority shareholder of the fund (with up to 100% ownership). However, as time passes, there would be other investors, and the fund manager's relative interest in the fund would be reduced to the point where the fund manager becomes a minority shareholder, or has no shareholding whatsoever as seed money is ejected. In such cases it can be challenging and judgemental to assess who is the principal/agent and has control over the life of the fund, and therefore when the fund manager and its group companies should consolidate and deconsolidate the fund in the group's financial statements. Often kick-out and termination rights of investors are a key consideration in such fact patterns.

e) *The link between power and returns – non-contractual agency relationships*

- A Panel member considered that if all available information does not support the conclusion that the investor has power, then the investor should consider the substance of the transaction and the relationship of the parties involved, particularly in cases where there is no contractual arrangement. For example, where multiple group companies each hold a small percentage of shareholdings in an investment and collectively hold a majority of the shares of an investee. If there is no contractual arrangement between these group companies, questions arise as to whether there is non-contractual agency relationship such that these group companies collectively control the investment. This Panel observed that in practice, it is difficult to rely only on the de facto agency guidance to argue that an investor has control over an investee. This Panel member also expressed his view that the de facto agency guidance discourages structuring opportunities, as the substance of the arrangement and relationships between parties have to be considered even there is no contractual arrangement between them.
- Another Panel member agreed that it is difficult to rely only on the de facto agency guidance to support whether an investor has control over an investee. On the other hand, it is also difficult to prove there is no de facto agency relationship when entities argue that there is

control. This is a difficult and controversial area. However, it is unavoidable as de facto agency relationships do exist in practice. Hence, this Panel member considered that it may be helpful to set a presumption that there is de facto agency relationship under certain situations, unless proven to be otherwise.

- A Panel member shared a practical situation where listed company disposed of its subsidiary and its business to a third party. Subsequent to the completion of the transaction, the buyer was not able to run the business due to financial difficulties. Though the buyer was the legal owner of the subsidiary and its business, the underlying operations and management continued to be carried out by the listed company. In this case, there could be a de facto agency relationship between the listed company and the buyer. This Panel member also considered that there may be de facto agency relationships in industries other than the fund industry.

f) Investment entities consolidation exception

- A Panel member noted that there is not much local experience of applying the investment entities consolidation exception. In particular, in the fund industry, multi-layered group structures usually exists. Investors set up layers of intermediate holding companies that are incorporated overseas (e.g. in the Cayman Islands) as fund vehicles. These overseas incorporated intermediate holding companies may need to present financial statements under their local laws and regulations. Questions arise as to whether these intermediate holding companies qualify as investment entities under IFRS 10. However, since these intermediate holding companies are incorporated overseas, any application issues relating to the investment entities consolidation exception is dealt with by overseas auditors.
- Other Panel members do not find the application of the investment entities consolidation exception to be common among Hong Kong entities.

g) Accounting requirements – Change in the relationship between an investor and an investee

- A Panel member noted that following the amendments to the definition of a business in IFRS 3, there are more cases where an acquisition of an entity is classified as an asset deal rather than a business combination under IFRS 3 because the acquired entity does not constitute a business according to the revised definition. For an asset deal, questions often arise as to whether an entity remeasures the previously held equity interest in the acquiree or applies a cost-based approach (i.e. no remeasurement of previously held equity interest). This Panel member considered that more guidance should be provided on this area.
- Three Panel members recommended that the IASB clarifies the accounting for loss of control in IFRS 10.25(b), in particular whether the requirement is applicable to disposals of a subsidiary when the subsidiary does not constitute a business, for the following reasons:
  - There is diversity in practice in accounting for a partial disposal of a subsidiary that

results in a loss of control and where the subsidiary does not constitute a business. Some entities remeasure the retained interest at fair value applying IFRS 10.25(b) while others adopt a cost-based approach (i.e. no remeasurement of the retained interest).

- Applying IFRS 10.25(b) to cases that involve a corporate wrapper (i.e. a company that is set up solely to hold an asset) may not always reflect the substance of the transaction or provide useful information to users. Similar comments were noted in the recent discussions by the IASB and IFRS Interpretations Committee on a submission about the sale of a subsidiary to a customer.[3]

- A Panel member considered that if the disposal involves a subsidiary that constitutes a business, then remeasuring the retained interest at fair value would provide relevant and useful information. However, if the disposal involves a corporate wrapper that only holds a single asset, e.g. real estate, then remeasuring the retained interest at fair value may not always provide relevant and useful information.
- Another Panel member also did not support remeasuring the retained interest at fair value in the case of a corporate wrapper, because remeasuring its retained interest would result in recognising an unrealised gain/loss on the retained interest, which may not provide relevant and useful information to users.
- Three Panel members noted that companies generally encountered practical difficulties in remeasuring retained interest at fair value. A Panel member noted that some companies did not take into account control premium or minority discount when remeasuring the retained interest at fair value. Two other panel members noted that there are practical difficulties in remeasuring the retained interest at fair value when the transaction does not have any consideration. This is common in the real estate and utilities industries where a change in control may result from changes in contractual terms without any consideration (e.g. change in the number of directors that the investor may appoint to the board of directors). However, these Panel members agreed that the application issues of remeasuring the retained interest at fair value are related to IFRS 13 *Fair Value Measurement*, and therefore are outside the scope of this project.

h) Accounting requirements – partial acquisition of a subsidiary that does not constitute a business

- Three Panel members noted that most investors recognise a non-controlling interest (NCI) for equity not attributable to the parent when an investor acquires control of a subsidiary that does not constitute a business. A Panel member noted that most subsidiaries hold only

[3] https://cdn.ifrs.org/-/media/feature/meetings/2020/june/iasb/ap12a-maintenance-and-consistent-application.pdf

assets before they start operation, and therefore do not constitute businesses. There may be an accounting issue when the subsidiary later constitutes a business if no NCI is recognised at the beginning. Another Panel member noted that in real estate industry, corporate wrappers are set up mainly to effect acquisitions and/or disposals, and are not intended to operate as businesses.

i) Accounting requirements – other comments

- A Panel member was concerned about the accounting requirement of attributing profit or loss and each component of other comprehensive income to the owners of the parent and NCI under IFRS 10.B94. In particular, this panel member considered that if a company continually makes losses, attributing the accumulated loss to NCI would result in a debit NCI, and this would not provide relevant and useful information to users if the NCI do not have any commitment to contribute further capital to the company. In particular, this panel member suggested the IASB provides guidance on when and how the debit balance of such NCI should be derecognised upon liquidation of the subsidiary, i.e. whether the debit balance should go through profit or loss similar to a disposal of a subsidiary (IFRS 10.B98) or through equity as a transaction with NCI (IFRS 10.B96).
- This Panel member also shared the following common application issues in the real estate industry in China:
    - Several investors set up a company to jointly bid on a piece of land. Each investor would manage and obtain returns from different section of the land independently from each other under the contractual agreement if the bid is successful.
    - For legal reasons, only one company can hold the legal title to the piece of land as a whole, and silo accounting cannot be applied. Each investor cannot account for its section of the land in its own balance sheet. In this Panel member's view, the current accounting practice may not faithfully represent the economics of the transactions because each of the other investors has the sole rights and obligations to develop their respective section of land.
    - This Panel member noted that there are debates as to whether 'silo accounting' under IFRS 10.B76-B79 or accounting for joint arrangements under IFRS 11 (if joint control exists) could be applied to this case.
    - Another Panel member suggested that in this case, it would be useful to identify the relevant activities and assess who has existing rights that give it the current ability to direct the relevant activities.

2. IFRS 11 *Joint Arrangements*

a) Collaborative arrangements outside the scope of IFRS 11

- A Panel member shared that collaborative arrangements that are outside the scope of IFRS 11 are common in the pharmaceutical industry and entertainment industry. For example, in the film production industry, the contractual terms of the collaborative arrangement specify who makes the decisions at different stages of production. These contractual terms usually demonstrate that one party has control and the other party might have significant influence over the arrangement. As joint control does not usually exist, the party cannot apply IFRS 11 in such arrangement. The panel member noted in practice, the non-controlling entities either account for such arrangements as investments in associates under IAS 28 or financial assets measured at fair value through profit or loss under IFRS 9. Technically, to account for such arrangement as associate would have similar issue to silo accounting as there is no legal boundary for the collaboration arrangement. This Panel member considered that it is preferable to account for such collaborative arrangement similar to a joint operation because this would more faithfully represent the substance of the arrangement.
- Another Panel member noted that collaborative arrangements that are outside the scope of IFRS 11 are prevalent in media industry. He shared that the parties to such collaborative arrangements usually account for their interests by analogy to the joint operation accounting in IFRS 11, and this may sometimes lead to similar accounting outcomes as applying IFRS 9. He also considered that there is a lack of guidance in IFRS on how the parties to such collaborative arrangements should account for their interests and suggested the IASB provides guidance on this area.

b) *Classification of joint arrangements*

- Two Panel members shared that it is common to consider “other facts and circumstances” to determine the classification of joint arrangements in the oil and gas industry, real estate industry and telecommunications industry.
- A Panel member suggested that the IASB should provide additional examples from the oil and gas industry to demonstrate how to assess the rights to the assets and obligations for the liabilities.
- A Panel member commented that the guidance which allows for considering “other facts and circumstances” in IFRS 11.B29-B33 give parties flexibility to modify the contractual terms of the joint arrangements and change the classification of the joint arrangements in order to achieve intended accounting outcomes. For example, a newly set up company is structured to give the party the rights to the assets and obligations for the liabilities, and therefore such arrangement is classified as a joint operation. Over a period of time, the

party recognises losses from the joint operation. The party may change the contract to give it the rights to the net assets of the arrangement, and reclassify the joint arrangement from joint operation to joint venture and apply equity accounting so as not to recognize the losses in excess of the cost of investment. However, this change in classification and accounting may not fully reflect the economic substance of the contractual arrangement. This Panel member commented that there is lack of guidance requiring entities to consider the economic substance of joint arrangements.

c) *Accounting requirements for joint operations*

- A Panel member shared that joint operations are common only in specific industries and therefore application issues of accounting for joint operations are not pervasive in Hong Kong.
- Two Panel members commented that the accounting requirements for joint operations in IFRS 11.20 are insufficient, and there is lack of guidance on how to determine the joint operator's share of interests.

3. IFRS 12 *Disclosure of Interests in Other Entities*

- The Panel generally considered that the disclosure requirements in IFRS 12 are adequate.
- A Panel member noted that IFRS 12.B10 requires an entity to disclose the summarised financial information of a subsidiary that has material NCI. He considered that the existing disclosure for material NCI is sufficient and there is no need to further expand the disclosure requirements.
- A Panel member suggested that SSD should reach out to investors to understand whether any of the existing disclosure requirements in IFRS 12 could be streamlined or removed yet still serving their information needs.