Meeting Summary of HKICPA Roundtable Discussion

Date: 8 April 2021, Thursday
Time: 4:00 p.m. – 6:00 p.m.

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

Ernest Lee, Chairman of Financial Reporting Standards Committee, HKICPA, and partner of Deloitte Touche Tohmatsu, welcomed participants and introduced the event.

Zhen Xu, IASB technical staff, provided an overview of the PIR and presented the areas of focus in the RFI. Rika Suzuki, IASB Board member, moderated the discussion. Jianqiao Lu, IASB Board member, and other IASB technical staff of the project team participated in the event.

IFRS 10 Consolidated Financial Statements

Relevant activities

- A practitioner shared his observations that it is common in the mining and pharmaceutical industries to have two or more investors each have rights to direct different activities, and those activities may occur at different times. For example, in a pharmaceutical company, one investor has the rights to direct the research and development of a new drug, while another investor has the rights to direct the manufacturing and marketing of the new drug. The importance of the activities may change over time (i.e. at the early stage, research and development are more important, while manufacturing and marketing are more important after the drug approval is obtained). It is challenging to make a judgement on the relative weighting of the importance of these activities, and whether there is a change of control over time when the importance of the activities changes over time. In practice, entities do not change their control over the investee over time in similar cases.
- Another practitioner echoed that it is common to see similar cases as the above. This practitioner considered the guidance in this area is comprehensive, and application of judgement is unavoidable.

Rights that give an investor power

- A preparer shared a case where the board of directors of a company includes both executive directors (ED) and independent non-executive directors (INED) for regulatory and corporate governance purposes, but these INED also have voting rights to protect the interests of the shareholders. It is challenging to determine whether the rights entitled to by the INED are substantive or protective as there seem to be conflicts between the governance structure and the guidance in the Standard. In practice, the number of INED and ED may be comparable, and this makes the assessment more difficult.
- Another preparer thought that it is necessary to understand the roles and legal obligations of the INED, e.g. whether they are supposed to protect the interests of the shareholders only, or if they also are to protect the rights of the creditors and other parties. It is also necessary to

understand the relationship between the company and these INED, and whether this may indicate a de facto agency relationship as per IFRS 10.B75.

- A practitioner considered that the critical question is how independent those INED are. This practitioner shared that if the case involves a listed company, the location where the company's shares are listed may impact the independence of these INED, which then may affect the assessment of whether their rights are substantive or protective.
- An investor considered that INED are normally not involved in the daily operations of a company, but they are involved in the governance and/or the statutory activities of the company. Hence, the rights held by the INED are generally not substantive because they do not have power over the relevant activities of the company as defined by IFRS 10.

Control without a majority of the voting rights

- A practitioner shared the experience that de facto control situations are common in Hong Kong and China. Challenges are often seen in how to make appropriate judgements, in particular for cases involving changes in judgement over time. Examples include:
    - Management concludes that there is de facto control based on the historical voting pattern of the shareholders. Due to a change in shareholding structure or issues discussed at shareholders' meetings, the voting pattern may change over time.
    - For a newly established company, where there is no historical voting pattern of shareholders, the conclusion of whether there is de facto control may change over time as voting patterns or other evidence can be gathered.
- A practitioner echoed that de facto control situations are common and are observed more frequently due to the increasing use of sophisticated structures. De facto control assessments sometimes links with de facto agent assessments; for example, how to apply the requirements appropriately among group companies where one company has substantial interest in an investee, and another related company has a minority interest stake in the same investee. This practitioner observed that companies generally prefer not to consolidate (i.e. argue there is no control) their investees. Furthermore, the Standard (IFRS 10.B46) provides room for management to apply judgement to argue that there is no control over the investee. It is also observed that the hurdle for loss of control is high, and guidance on loss of control is not clear in the Standard. This practitioner considered that standard-setters may not be able to resolve this matter and more stringent regulatory enforcement may be is required, because standard-setters cannot mandate the critical judgements to be made by management in these cases.
- An investor agreed with the comments from other participants. This investor also shared the view that the composition of the board of directors and the daily operating and financial reporting structure of the entity are also key factors to consider, and can support the judgement made by the management in assessing whether there is de facto control.

Principals and agents

- A preparer considered that the overall flow of the assessment of control is not always well aligned to what is being assessed. For example, in the fund industry, the investor engages the fund manager through contract and delegates investment decision rights to the fund manager. The examples accompanying the Standard (Examples 13-15) illustrate the application of the guidance to identify whether the investor or the fund manager is the principal when assessing the link between power and returns. In the case that the investor is not a fund manager, after determining the fund manager is an agent of the investor, the investor then has to consider again whether it has power over the investee and its exposure to variable returns, before concluding whether it has control over the investee.
- A practitioner shared that frequent questions arise as to what is the threshold when determining whether a decision maker is an agent or a principal. Companies often would like to use such a threshold to structure their transactions to achieve designated accounting outcomes. The principles in IFRS 10 are conceptually appropriate, but are is judgemental to apply. This practitioner also shared some examples of cases where challenges often occur in performing the principal and agent assessment:
    - a simple lending arrangement is structured as an investment in debt securities;
    - where there are increasing regulatory requirements for trust structures that empower trust managers entitle more rights, e.g. veto rights, to protect the minority shareholders.
- Another practitioner shared that the existing examples in IFRS 10 are helpful. However, these examples are specific to investment funds. This practitioner suggested the IASB include other non-industry specific examples to illustrate the general application of the guidance. However, another practitioner considered that specific examples may lead to unintended consequences, such that stakeholders may interpret the examples as a ‘bright line’ in determining the decision maker as a principal or an agent, while in practice such a threshold may differ by jurisdiction and depend on other factors. Comprehensive examples may not be helpful or suitable for all jurisdictions. This practitioner suggested the IASB considers working with local standard setters to develop local illustrative examples.
- A preparer echoed that it would be helpful if the IASB considers developing simple examples to demonstrate the principles.

Non-contractual agency relationships

- A preparer shared that the examples listed in IFRS 10.B18 seem to imply that contractual arrangements could be ignored (i.e. one could consider mainly non-contractual arrangements). IFRS 10.B75 provides examples that may indicate a de facto agency relationship. There is no guidance on how to determine the weighting for contractual and non-contractual arrangements, and sometimes this may lead to different outcomes relying on contractual or non-contractual relationship. However, this preparer considered that the principle of non-contractual agency relationships should not be an overriding principle.
- A practitioner observed that a non-contractual agency relationships are frequently seen. For example, in China, it is common to use a platform to hold a listed company’s shares on behalf of the employees due to local regulatory restrictions. However, this is not common in Hong Kong.

Investment entities consolidation exception

- A practitioner noted that an investment entity may provide investment-related services and management services under IFRS 10.B85C and IFRS 10.B85D. However, this practitioner observed that there is diversity in practice in how 'investment-related services' and 'management services' have been interpreted, particularly in real estate investment trusts. This practitioner suggested that the IASB should provide further guidance or illustrative examples on which services an investment entity can provide.
- Another practitioner would like to clarify the requirements on exit strategies, in particular:
  - the extent of documentation required to provide evidence that the investment entity has an exit strategy for its investments.
  - for investments that have the potential to be held indefinitely, whether there are any requirements (e.g. upper limits) for how long an investment entity could hold the investments; for example, whether the company could hold the investments for 80 to 100 years.
- An investor considered that requiring an investment entity to measure at fair value an investment in subsidiary that is an investment entity itself (instead of consolidating the assets and liabilities of the subsidiary) results in loss of information about the results, investments, assets and liabilities held by the intermediate subsidiary. This investor considered that such information is useful for investors to analyse the financial performance and position of the intermediate subsidiary, and could not be compensated for by providing additional disclosures.
- A practitioner also agreed that applying the requirements in IFRS 10.32 would result in loss of information about the intermediate subsidiary, in particular for wholly-owned intermediate subsidiaries that are set up solely for tax purposes (e.g. to minimise tax payment by the investors in the group). This practitioner noted that the IASB had considered requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes but had decided against this. This practitioner suggested that the IASB reconsiders the accounting for intermediate subsidiaries in this case.
- A practitioner noted that some entities would provide voluntary disclosures about the intermediate subsidiaries to meet users' information needs, and users generally found the additional information useful. Accordingly, this practitioner suggested that the IASB considers requiring companies to provide additional disclosures about intermediate subsidiaries instead of changing the existing measurement approach in IFRS 10.

Accounting requirements – change in the relationship between an investor and an investee

- A practitioner noted that following the amendments to the definition of a business in IFRS 3, there are more cases where an acquisition of a company is classified as an asset deal rather than a business combination under (because the acquired company does not constitute a business according to the revised definition). This practitioner questioned, for an asset deal, whether a company should remeasure the previously held equity interest in the acquiree or apply a cost-based approach (i.e. no remeasurement of previously held equity interest).
- This practitioner also shared an application issue on transactions involving single-asset entities. In particular, in the real estate industry, questions arise as to whether a company that sells its properties through a corporate wrapper (which is a wholly-owned subsidiary of the company) should account for the transaction as sale of properties under IFRS 15 (which reflects the substance of the transaction) or as a disposal of a subsidiary under IFRS 10 (which follows the form of the transaction). This practitioner noted that similar issues were discussed by the IASB and IFRS Interpretations Committees (IC) on submissions about the sale of a subsidiary to a customer, and the sale and leaseback of an asset in a single-asset entity. However, this practitioner noted that there seems to be inconsistency in the IC's analysis and conclusions on the two issues. In particular, this practitioner considered that the underlying

question in both situations is similar – i.e. whether the form of a transaction (sale of an equity interest in a single-asset entity rather than a direct sale of the asset within the entity) would result in any difference in accounting for the transaction. The IC's analysis for the accounting for the sale of a subsidiary to a customer seems to follow the substance of the transaction while the other seems to follow the form of the transaction. This practitioner recommended that the IASB clarifies the accounting treatment in these cases.

- Two practitioners also noted that transactions involving single-asset entities/corporate wrappers are common in the real estate industry in Hong Kong and China. Accordingly, they strongly recommended that the IASB considers the accounting for transactions involving single-asset entities more holistically in this project.
- Another practitioner shared the following two application issues:
    - 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 companies remeasure the retained interest (being an equity-accounted investee) at fair value applying IFRS 10.25(b). Others adopt a cost-based approach (i.e. no remeasurement of the retained interest) because these companies considered that remeasuring the retained interest at fair value would result in recognising an unrealised gain/loss on the retained interest, and this would not reflect the substance of the transaction.
    - It is common in the real estate industry in Hong Kong and China that a change in control may result from changes in contractual terms, without paying any consideration (e.g. changing the clause in the article of associations so that a company may appoint more/less board of directors). This practitioner questioned whether in this case, remeasurement of the investee would be appropriate and reflect the substance of the transaction.

IFRS 11 *Joint Arrangements*

Classification of joint arrangements

- A practitioner shared that it is not common to consider other facts and circumstances to determine the classification of a joint arrangement, and joint arrangements only occur in certain industries. The practitioner 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 hence change the classification in order to achieve intended accounting outcomes. This change in classification and resulting accounting may not fully reflect the economic substance of the contractual arrangement. The practitioner also commented that it is not easy to understand when to apply 'other facts and circumstances' in the assessment, and it may hence be ignored or not appropriately considered in practice.
- A preparer shared that one group company set up a joint arrangement with the government through a separate vehicle, but the parties want to share in the underlying assets only. The preparer commented that it is difficult to draft the contractual terms to separate the obligations for the liabilities of the arrangement to achieve classification as a joint operation if the joint arrangement is structured through a separate vehicle.
- A practitioner echoed the preparer's comment that it is difficult to satisfy 'other facts and circumstances' to classify the joint arrangement as a joint operation if the joint arrangement is structured through a separate vehicle. This practitioner shared a case where a joint arrangement was structured through a separate vehicle, and the venturer signed a tenancy

agreement of a property of the joint arrangement with a landlord. From the legal perspective, the property is the asset of the separate vehicle, and it was concluded that the joint arrangement was a joint venture. The practicioner commented that it is difficult for other facts and circumstances to override the legal form of a separate vehicle and to classify such a joint arrangement as a joint operation.

- A practitioner shared an application issue in the real estate industry in China where several companies were set up to jointly bid on a piece of land. Each company had different investors, and each company would share in a different section of the land if the bid was successful. For legal reasons, only one company could hold the legal title to the piece of land as a whole, and therefore this company recognised the whole piece of land in its financial statements. This practitioner considered that the current accounting practice may not faithfully represent the economics of the transactions because each of the other companies has the sole rights and obligations to develop their specific sections of land. This practitioner noted that there are debates as to whether "silo accounting" under IFRS 10.B76-B79 or accounting for joint operation under IFRS 11 (if joint control exists) could be applied to this case.

Collaborative arrangements outside the scope of IFRS 11 and accounting requirements for joint operations

- A practitioner considered that there are gaps in the Standards on collaborative arrangements outside the scope of IFRS 11, and on how to determine a joint operator's share of assets, liabilities, revenue and expenses when the share of output purchased differs from its share of ownership interest in the joint operation. This practitioner recommended the IASB to address these areas as current practice may not reflect the economic substance of the arrangements, and it is expected that these arrangements will be more pervasive in the future, particularly in the development of 5G services in the telecommunication industry.
- A practitioner 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 is responsible for film production and distribution. It is challenging to determine whether the parties have control or joint control in the arrangement. If there is a lack of joint control in the arrangement and the arrangement is not structured through a separate legal entity, they are often accounted for as an associate if the party has significant influence on the arrangement. This practitioner questioned whether it is appropriate to apply equity accounting in such an arrangement as there is no legal boundary for such collaborative arrangement.

IFRS 12 *Disclosure of Interests in Other Entities*

- A preparer considered that disclosure of share of revenue, earnings, assets and liabilities of associates/joint ventures in segment reporting may provide useful information to investors and recommended that the IASB considers allowing a choice or option for disclosure of share of significant associates/joint ventures' revenue, earnings, assets and liabilities in segment reporting in IFRS 8 *Operating Segments*. A practitioner explained that such presentation is not commonly seen in practice, and it may only be common in the real estate industry. This practitioner explained that a company can provide such disclosure in segment reporting if the amounts are reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance.

- A preparer noted that typical customer-supplier relationships are excluded from the definition of interest in other entities and will not fall into the disclosure requirements in IFRS 12. However, it is common to have customer-supplier relationships in the aircraft leasing industry which are usually arranged through a structured entity. This preparer noted inconsistencies in practice with the extent of disclosures under IFRS 12 in relation to such arrangements (i.e. whether excluded or included as structured entities under IFRS 12). This preparer recommended that the IASB considers clarifying this matter.