ACTIVITIES OF THE FINANCIAL REPORTING INVESTIGATION PANEL IN 2019

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ACTIVITIES OF THE FRIP IN 2019

The JSE issues an annual report (in February) providing feedback on its proactive monitoring activities. The activities of the Financial Reporting Investigation Panel (**"**FRIP**"**) are included as an annexure to that report. The FRIP provides advice to the JSE on cases of possible non-compliance with financial reporting requirements.

This document is being published in advance of the 2020 report and discuses four cases considered by the FRIP.

Case 1

Venture capital exemption in terms of IAS 28

The issuer held a number of businesses in another jurisdiction through a structure that was an associate and was previously equity accounted. In the year under review they elected to measure these operations at fair value through profit and loss, using the venture capital exemption in IAS 28.18, *Investments in Associates and Joint Ventures* ("IAS 28").

Whilst paragraphs 18 and 19 of IAS 28 deal with accounting for investments held by venture capital organisations, a venture capital organisation is not defined in IAS 28 or elsewhere in IFRS.

The FRIP concluded that, even though a venture capital organisation is not defined in IFRS, the Basis for Conclusion to IAS 28 provides an indicator (in BC 19I) that such organisations represent "*a narrow population*" and hence, there are not many entities of this nature. Based on the information presented to the FRIP, the investments did not seem to meet what would reasonably be considered as criteria for, or characteristics of, a venture capital organisation.

Furthermore, the FRIP considered there to be similarities between a venture capital organisation and an investment entity as described in IFRS 10. The structure through which the issuer held its investments in the foreign operations was a common phenomenon in groups and the nature of their structure did not seem to align with the definition of an investment entity, as set out of IFRS 10.

In respect of the appropriateness of the change in accounting policy, the issuer explained that the investment objective through this foreign structure had changed during the financial year, resulting in it being treated as a venture capital division of the group from the date of such change. The FRIP decided that even if it could have been regarded as venture capital organization (which per the above discussion was not the case), IAS 28 (the 2011 version which was applicable for the results under question) specifically required a fair value election to be made only at initial recognition of the investment. There was no option to change the accounting treatment thereafter from equity accounting to fair value. All but one member of the review committee was therefore of the opinion that the change in accounting policy was inappropriate and not in line with the guidance in paragraphs 10 and 11 of IAS 8, *Accounting Policies, Changes in Estimates and Errors* ("IAS 8"), and the clarifications provided in the 2016 amendments to IAS 28.

Case 2

Property investment – consolidation

The issuer held a 32.7% share in a company (X Limited), which was increased to 53.5% in the year under review. The purpose of X Limited was to obtain loans to fund the acquisition of buildings, further develop these and lease out the properties. Despite the shareholding exceeding 50%, the issuer continued to account for the investment as an associate on the basis that the shareholding was less than 75 %, which it deemed to be the mandated majority for decisions of reserved matters per X Limited's memorandum of incorporation ("MOI").

Detailed consideration was given to the content of the specific clauses within the MOI and the FRIP agreed unanimously that a number of the reserved matters (that were subject to shareholders approval at a special resolution level) were protective in nature.

A majority of the members of the review committee were of the opinion that some of the reserved matters were of a much more substantive nature and that the ability to direct the relevant activities therefore rested with the shareholders, through special resolution. Therefore, there was no clear indication that the issuer controlled X Limited.

A minority were of the opinion that all of the reserved matters as set out in the MOI of X Limited, were only protective in nature, and not related to the relevant activities as intended by IFRS 10. Therefore, they were therefore of the view that the issuer controlled X Limited and it should be consolidated as required by IFRS 10.

In this particular case the JSE decided not to pursue the matter any further.

Case 3

Consolidation of an empowerment trust

In this instance the issuer formed an education trust, with primary objective of introducing an empowerment partner for the group. At the time of formation, the trust purchased 15% of the issued share capital of an operating subsidiary of the group, utilising an irrevocable donation it received from the issuer. The subsequent operating activities of the trust were funded from dividends earned from its shareholding in the operating subsidiary. On an annual basis, a discretionary amount was determined by the issuer and paid via dividends to the trust. This dividend was applied to support the trusts activities, which mainly involved awarding bursaries to students.

In terms of the trust deed, the issuer had the right to appoint the trustees and, since the trusts' formation, the trustees were those selected by the issuer. The trust deed originally required the use of the donation to acquire shares in the operating subsidiary and these remained the investments of the trust. The current and past investment direction was dictated by the trustees appointed by the Issuer.

Despite the fact that the issuer appointed the trustees of the trust, the trustees were not required to obtain approval from the issuer or any other party in order to execute their duties; the issuer had no right to repurchase the shares held by the trust; and the trustees were empowered to dispose of the investments of the trust as they deem fit. The issuer was not, directly or indirectly exposed to any financial returns from the trust and did not guarantee the performance of the trust or provide loan funding in any form to the trust. Furthermore, there were no restrictions precluding the trust from making additional investments or disposing of the original shares.

The focus for the FRIP was the consolidated financial statements of the issuer (i.e. the listed entity) only, and not the financial statements of the trust or the entity itself.

Economic substance of the transaction

Key to considering the transaction was the understanding of the power over the relevant activities of the trust in relation to the shares. Whether it was a direct donation of shares, or seed capital that was required to be used to acquire the shares, was considered to be irrelevant. Prior to the donation, the shares (being unissued), were under the power of the issuer. Subsequent to the donation (considering that the trustees had full discretion over the investment direction) the current and past investment direction were dictated by the issuer. The issuer did acknowledge that it had the power over the relevant activities of the trust.

The FRIP considered that, in substance, the shares issued to the trust and its related dividends were merely a legal conduit to ensure that this discretionary amount of cash was channeled to the trust for distribution purposes in line with the issuer's corporate social investment ("CSI") mandate. The trust was a vehicle to further the issuer's BEE credentials and social investment activities, hence supporting its corporate citizenship role. [In addition to the original BEE status achieved through the establishment of the trust, the impact that the ongoing activities of the trust had on the issuer's reputation was expected to provide an advantage to the issuer when transacting in the South African environment, for example tendering for business.]

As the issuer has no recourse on the donation and there were no put or call options in place between the trust and the issuer, the FRIP further considered whether the shares would be seen as issued (at a later date). It was noted that, if the shares were to be controlled by independent third party, then they would be considered as having been issued. This could occur if, for example, the trust was to dispose of the shares to a third party, or if the issuer relinquished its power (embedded in the trust deed) over the relevant activities of the trust. Notwithstanding these considerations, the FRIP concluded that this had not yet occurred and the shares should be treated as not having been issued. This further supported that the view that the structure was merely the round tripping of the cash- the issuer did not raise any additional capital through the issue of the shares.

As the shares were, in substance, not considered to have been issued, the FRIP concluded that there was also no non-controlling interest in the equity instruments of the issuer. Beneficiaries of the scheme only benefited to the extent of dividends that were paid as bursaries. Capital appreciation of the shares remained under the power of the issuer (via the appointment of the trustees).

Further, the dividends relating to the affected shares remained within the issuer. There in substance not paid by the issuer, and should therefore not have been recognised as a distribution to shareholders. Instead, a CSI expense should have been recognised as and when bursaries were granted by the trust. Such expenditure should have been recognised in the Statement of Profit or Loss, rather than in the Statement of Changes in Equity.

Comments on IFRS 10 control criteria

The FRIP considered whether the issuer met the requirements as set out in IFRS 10.07 in respect of controlling the investee. The issuer had the power over the investee's relevant activities by virtue of having the ability to appoint the trustees. This also afforded the issuer the ability to use its power over the trust (through the appointment of trustees) to change and amend arrangements and decisions by the trust. The trust deed clearly stated that the donation by the issuer at the time of establishing the trust, had to be used to buy shares in the operating subsidiary.

In respect of the exposure or rights to variable returns, the issuer obtained, and continued to obtain, non-financial benefits from the trust, most pertinently in the form of its BEE ownership and CSI credentials. Therefore the FRIP was of the view that there were strong grounds for the trust to be consolidated. However, as the substance of the trust was merely that of a conduit for cash disbursements to (primarily) students, and that the shares were considered in substance not to have been issued (i.e. not an asset of the trust), the accounting consequences of consolidation would result in a similar accounting treatment for the issuer as concluded above.

Consideration as to the existence of a non-controlling interest

The FRIP was of the opinion that, the shares were fully under the control of the issuer and no non-controlling interest existed.

Case 4

Disclosure of non-IFRS performance measures as part of segmental reporting

This matter involved a number of issuers (mainly in the REITs sector), relating to the appropriateness of disclosing entity-wide performance measures (non-IFRS disclosures) within the IFRS 8, *Operating Segments* ("IFRS 8"), analysis note of the annual financial statements ("AFS"), as well as the appropriateness of including 'other' information within the AFS, which create the impression that it is IFRS information.

Segmental information

This concept of providing additional disclosures beyond the IFRS requirements is addressed in paragraphs 17(c) and 31 of IAS 1. IFRS 8.20 states that the objective of the standard is to allow the users of the financial statements to evaluate the nature and financial effect of business activities.

The IFRS 8 disclosures focus on the measures of performance of each segment (which per IFRS 8.5 is a component of the entity) used by the chief operating decision maker to allocate resources to, and assess the performance of, the segments.

Since the alternative performance measures in question were provided only on an entity-wide basis (they were not calculated and used by the chief operating decision maker at a segment level), the FRIP was of the opinion that the placement of these entity-wide alternative performance measures within the segment report was not in line with the purpose of the IFRS 8 disclosures. Although IFRS 8 does require specified entity-wide disclosures to be provided, the purpose of such disclosures is to provide more disaggregated information on an IFRS basis. For example, information is required about different products and services, different geographical areas and major customers.

Whilst the inclusion of entity-wide alternative performance measures in the financial statements is not prohibited by IFRS (including IFRS 8), the FRIP was of the opinion that the placing of such entity wide performance measures was not intended to form part of the IFRS 8 disclosure.

The inclusion of other information, with specific reference to alternative performance measures, as part of IFRS disclosure, not specifically required by IFRS

The integrity of financial reporting as set out in terms of IFRS should be guarded. Therefore, users should have certainty as to the labelling of information – that segmental information is actually that, and not an alternative performance measure.

This is supported by the principle in IAS 1.85A in respect of the prominence of non-IFRS disclosure, which aims to ensure that other information is not more prominent than IFRS disclosures, as this could lead to confusion. If alternative performance measures (not defined in IFRS but included among other IFRS required disclosures) are not identified as such, this may not result in faithful representation. Users might be unaware, in the absence of appropriate labelling and explanations, that these are non-IFRS measures.