IFRS Discussion Group

Report on the Public Meeting

July 19, 2012

The IFRS Discussion Group is a discussion forum only. The Group's purpose is to assist the Accounting Standards Board (AcSB) regarding issues arising on the application of International Financial Reporting Standards (IFRSs) in Canada. The Group comprises members with various backgrounds who participate as individuals in the discussion. Any views expressed in the public meeting do not necessarily represent the views of the organization to which a member belongs or the views of the AcSB. The discussions of the Group do not constitute official pronouncements or authoritative guidance.

This document has been prepared by the staff of the AcSB and is based on discussions during the Group's meeting.

Comments made in relation to the application of IFRSs do not purport to be conclusions about acceptable or unacceptable application of IFRSs. Only the IFRS Interpretations Committee or the International Accounting Standards Board can make such a determination.

(*For a full understanding of the discussions and views expressed at the public meeting, listen to the audio clips*).

Items Presented and Discussed at the July Meeting

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Update on Previous Issues the Group Recommended Be Referred to the IASB or the IFRS Interpretations Committee

Update on the IFRS Interpretations Committee's Outreach Requests

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ITEMS PRESENTED AND DISCUSSED AT THE JULY MEETING

Comprehensive Revaluation of Assets and Liabilities

Under pre-changeover accounting standards in Part V of the CICA Handbook – Accounting, the standards for "comprehensive revaluations" of assets and liabilities are set out in Section 1625 *Comprehensive Revaluation of Assets and Liabilities*. Under this standard, the assets and liabilities of an enterprise could be comprehensively revalued only when:

1. virtually all of the equity of the enterprise had been acquired by an unrelated party (in this case, the revaluation was optional); or
2. the enterprise has undergone a financial reorganization and control over the enterprise has changed (in this case, the revaluation was mandatory).

In both situations, a new cost basis would be established for the enterprise's assets and liabilities.

As IFRSs do not contain guidance that is similar to Section 1625, questions have arisen as to whether a similar approach would be appropriate in these two situations once the enterprise has adopted IFRSs.

The issue considered by the Group was whether comprehensive revaluation is possible under IFRSs in some circumstances (*View A*) or conflicts with IFRSs in all circumstances (*View B*). Specifically, questions may arise as to whether an entity can apply a comprehensive revaluation approach under IFRSs when virtually all of the equity of the entity has been acquired by an unrelated party or the entity has undergone a financial reorganization.

The Group's Discussion

Group members supported View B, noting that comprehensive revaluation of assets and liabilities conflicts with IFRSs and it is not possible to support this approach under IFRSs regardless of the circumstances. Group members observed that IFRSs represent a complete set of recognition and measurement standards that should be applied in the above situations. Analogizing to Section 1625 under paragraph 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* results in a direct conflict with clear IFRS standards and, as a result, is inappropriate.

Gord Fowler, Chair of the AcSB, also noted that recently there have been outreach from, and informal discussions by, the IFRS Interpretations Committee regarding the narrow use of push-down accounting allowed under U.S. GAAP. These activities demonstrated that there is little or no interest in the IASB or the Committee taking on a project on push-down accounting. They support the conclusion that no action by the AcSB is necessary given that the question has already been asked at a global level.

The Group agreed that this issue should not be brought to the attention of the IFRS Interpretations Committee because diversity is not expected to emerge in practice.

Presentation of Combined Financial Statements

Combined financial statements, unlike consolidated financial statements, are presented for separate entities that do not exist as a "single economic entity" (i.e., there is no parent-subsidiary relationship amongst the entities). Combined financial statements are prepared by "combining" the financial statements of various entities or businesses that do not constitute a single group to provide the historical financial performance of such entities or businesses.

Reporting issuers may file combined financial statements for certain regulatory filings, with the representation that such combined financial statements provide information about the substance of a proposed internal re-organization (for example, the spinoff of various entities to a new entity which plans to go public). Such information may be considered relevant to investors who are investing in entities that are under common control or under common management.

In Canada, some entities prepared combined financial statements in the past, especially in regulatory filings such as prospectuses or information circulars. Pre-changeover Canadian accounting standards included some guidance on the presentation of combined financial statements in *Consolidated Financial Statements*, paragraphs 1600.04-.05, in Part V of the CICA Handbook – Accounting.

The issue considered by the Group was whether the presentation of combined financial statements is appropriate under existing IFRSs, and when such presentation would be considered appropriate.

The Group's Discussion
Group members noted that IFRSs do not provide guidance on the presentation of combined financial statements. Group members observed that entities applying IFRSs do issue combined financial statements in a variety of circumstances and may do so, in part, because of the requirements of Canadian securities regulations. Cameron McInnis, Chief Accountant of the Ontario Securities Commission, noted that these requirements do not necessarily require combined financial statements to be presented. Reporting issuers are encouraged to consult with securities regulators early in the process to determine whether combined financial statements are appropriate and necessary for a particular fact pattern, especially when the entities being combined are under common management rather than common control.

Some Group members noted it would be helpful if Canadian securities regulators were to clarify when combined financial statements are considered necessary.

Group members discussed when combined financial statements may be considered appropriate, noting co-operatives and real estate property management as examples. Some Group members commented that combined financial statements may be appropriate in circumstances involving common control or common management but that the specific facts and circumstances need to be considered, especially in respect of entities or businesses under common management.

Some Group members cautioned that combined financial statements are not appropriate in circumstances when IFRSs provide guidance on how to account for an inter-corporate investment (for example, when a significant influence relationship exists) and combined financial statements would override the required accounting treatment. However, combined financial statements may be appropriate when no relationship exists for which IFRSs provide guidance and the presentation of combined financial statements would be useful and is permitted by securities regulators.

Some Group members expressed concern with the lack of guidance in IFRSs about how to prepare combined financial statements under IFRSs. Other Group members expressed the view that this lack of guidance should not preclude preparation of combined financial statements in circumstances when providing this information would be useful.

Group members observed that, in January 2010, the IFRS Interpretations Committee considered and rejected adding this issue to its agenda, noting "that the ability to include entities within a set of IFRS financial statements depends on the interpretation of 'reporting entity' in the context of common control." In addition, in July 2012, the Committee reconsidered this decision as part of a review of all issues that the Committee referred to the IASB from January 2008 to May 2012 (excluding annual improvements). The Committee supported the staff's recommendation that this issue should not be reconsidered because the issue "should be considered as part of the IASB's project on business combinations under common control and, as applicable, the IASB's work on the reporting entity chapter of the *Conceptual Framework*."

Group members observed that the Group's conversation is being replicated globally. As a result, although guidance would be helpful, it is unclear what the AcSB can do to change or accelerate current global activities regarding this issue. Although the AcSB staff will monitor the global activities, this work will likely take some time to complete. In the short term, reporting issuers are encouraged to continue to consult often and early with Canadian regulators and watch for future communications from Canadian regulators on this topic.

The Group agreed that this issue should not be brought to the attention of the IFRS Interpretations Committee because the issue is already being considered globally.

IFRS 2, IAS 32 and IAS 33: Modification of Share Purchase Warrants

Shares and share purchase warrants are often issued together as private placement units. The shares and warrants are issued to raise capital and are not issued in exchange for goods or services. In circumstances when both the shares and warrants are classified in equity in accordance with IAS 32 *Financial Instruments: Presentation,* the fair value of the proceeds of the units is allocated to separate components of equity – share capital and warrants.

The terms of the warrants may be modified prior to or near maturity by extending the expiry date or changing the exercise price, or a combination of both, and the modification will often affect the fair value of the warrants.

Accounting for modifications to the terms of equity instruments that were not issued in exchange for goods or services (i.e., not granted under IFRS 2 *Share-based Payment*) is not specifically addressed in IAS 32 or in other IFRSs. However, IFRS 2 does contain guidance on modifications to the terms and conditions of equity instruments that were granted in exchange for goods or services.

The issue considered by the Group was what accounting treatment is appropriate, including any effect on earnings per share, when the terms of warrants that were initially classified as equity are modified. The modifications were not in exchange for goods or services and were provided to the whole class of warrant holders.

Issue 1: Are the modifications to the terms of the warrants issued for proceeds (rather than goods or services) subject to IAS 32 (*View A – no adjustment to profit and loss*) or IFRS 2 by analogy (*View B – adjustment to profit and loss*)?

Issue 2: If the modifications to the terms of the warrants are addressed by IAS 32 (*View A*), should an adjustment to equity be recognized (*View A1*) or not recognized (*View A2*), or does an accounting policy choice exist (*View A3*)?

Issue 3: Should the modifications to the terms of the warrants have no affect (*View C*) or have an affect (*View D*) on the computation of basic earnings per share in accordance with IAS 33 *Earnings per Share*?

The Group's Discussion

Group members observed that prior to considering the first issue, an entity should consider whether a modification to the price or number of shares disqualifies the instruments for equity presentation under the "fixed for fixed" requirements in IAS 32, thereby requiring the instruments to be presented as liabilities. Group members noted that the context of the modification should be understood when making this assessment and that these modifications are often given to encourage the warrant-holders to inject additional funds.

Assuming that it continues to be appropriate to present the instruments in equity, Group members supported the view that modifications to the terms of the warrants in the fact pattern being considered are subject to IAS 32 and do not affect profit and loss (i.e., View A). Group members observed that because the instruments were accounted for under IAS 32 before the modification, the standard continues to apply after the modification and it is inappropriate to apply IFRS 2 by analogy.

When considering Issue 2, many Group members preferred View A1 but would also accept View A2, noting that an accounting policy choice exists (i.e., supporting View A3). When considering Issue 3, some diversity in views was expressed on whether modifications to the terms of the warrants should affect the computation of basic earnings per share. However, Group members noted that a consistent approach should be taken to the second and third issues (i.e., if an adjustment is not recorded to equity, the calculation of earnings per share should not be affected and vice versa).

Group members observed that although Issues 2 and 3 are interesting topics for discussion, these issues are not the most important and, as a result, the difference in views was not explored further. In contrast, Group members noted that the first issue is quite important along with the fact that all Group members supported that a modification to the terms of the warrants in this particular fact pattern does not affect profit and loss (i.e., View A).

The Group agreed that this issue should not be brought to the attention of the IFRS Interpretations Committee because significantly divergent interpretations are not expected to emerge in practice.

IFRS 11: Classification of a Bare Trust Set Up for a Real Estate Project

Under common law, a bare trust (also known as a simple trust or a naked trust) refers to a specific type of trust in which the trustee holds property without any further duty to perform. A bare trust may be used to hold real estate property. Bare trusts also have a specific tax treatment under Canada Revenue Agency rules.

IFRS 11 *Joint Arrangements* requires an entity to classify a joint arrangement as a “joint operation” or a “joint venture” (which are defined in paragraphs 15 and 16). This classification is important because the accounting treatment depends on the type of joint arrangement.

The issue considered by the Group was whether a joint arrangement that uses a bare trust to hold real estate property should be classified under IFRS 11 as a joint operation or a joint venture.

Fact Pattern:
Company A and Company B will enter into a joint arrangement to develop land and construct and sell residential dwellings to third parties. The arrangement calls for the use of a bare trust to

hold the land until such time as it is developed and sold. Neither company will occupy the residential dwellings upon completion. The terms of the arrangement are set out in a co-ownership agreement as follows:

- Company A will purchase an undivided 50 percent interest in land owned by Company B.
- Company A and Company B will each convey their respective undivided 50 percent interest in the land to a bare trust, which will hold the land for the purposes of the development. The trustee of the bare trust is an independent third party with no beneficial interest in the property or the development. The conditions to qualify as a bare trust for tax purposes are met.
- All decisions about the relevant activities (for example, construction, development, and management) of the co-ownership will require the unanimous consent of Company A and Company B.
- The parties share all interests in the assets, liabilities, obligations, costs and expenses relating to the co-ownership in proportion to the parties' ownership interest in the arrangement.
- The joint arrangement partners are entitled to share equally in the capital and profits of the co-ownership arrangement.

Does the existence of the bare trust in the above fact pattern result in the co-ownership arrangement qualifying to be accounted for as a joint operation (*View A*) or a joint venture (*View B*)?

View A – Joint operation (i.e., account for the assets owned and liabilities incurred under the arrangement)

Proponents of this view look to paragraphs B16 and B21 of IFRS 11. Proponents of this view argue that the bare trust is only in place for tax reasons and does not confer legal separation between the parties and the land.

The bare trustee does not have any independent power, discretion or responsibility pertaining to the trust property. Instead, the beneficial owners (Company A and Company B) retain the right to control and direct the trustee in all matters relating to the trust property.

As a result, proponents of this view argue that the arrangement in this fact pattern qualifies as a joint operation.

View B – Joint venture (i.e., account for the arrangement using the equity method)

Proponents of this view argue that the bare trust represents a separate vehicle. Under the co-ownership agreement, the joint arrangement partners are entitled to share equally in the capital and profits of the co-ownership arrangement, which is indicative of a joint venture in accordance with paragraph B27 of IFRS 11.

As a result, proponents of this view argue that the arrangement in this fact pattern qualifies as a joint venture.

The Group's Discussion

Group members observed that although a bare trust is a separate vehicle, this fact is not sufficient to conclude that the joint arrangement qualifies as a joint venture (i.e., View B is not supported). Further, Group members observed that in this relatively simple fact pattern, the existence of the bare trust does not prevent the arrangement from qualifying as a joint operation (i.e., Group members supported View A).

The Group observed that paragraph B21 of IFRS 11 states that:

> "As stated in paragraph B15, when the parties have structured a joint arrangement in a separate vehicle, the parties need to assess whether the legal form of the separate vehicle, the terms of the contractual arrangement and, when relevant, any other facts and circumstances give them:
> (a) rights to the assets, and obligations for the liabilities, relating to the arrangement (ie the arrangement is a joint operation); or
> (b) rights to the net assets of the arrangement (ie the arrangement is a joint venture)."

Group members observed that the bare trust is a separate vehicle that does not confer separation and the assessment required under paragraph B21 of IFRS 11 for this relatively simple fact pattern supports a conclusion that the arrangement qualifies as a joint operation.

In contrast, Group members noted that at the January 2012 meeting, the Group's discussion on "IFRS 11: Classification of Limited Partnerships Subject to Joint Control" provided an example involving a separate legal vehicle that does confer separation and, as a result, the legal form in the fact pattern discussed at that meeting was not sufficient to conclude that the joint arrangement qualified as a joint operation.

Group members observed that a bare trust is a special type of trust that does not confer separation. As a result, Group members noted that View A can be supported only in this specific fact pattern involving a bare trust and cautioned that it would not be appropriate to apply this analysis by analogy to all trusts. Generally, a trust will not be considered to be a bare trust when the trustee has other duties that involve independent or discretionary powers and responsibilities. As a result, other types of trust may confer separation and a careful analysis of all of the facts is necessary when assessing the classification of a joint arrangement under IFRS 11.

Group members observed that qualifying as a bare trust under Canada Revenue Agency rules is a key fact needed to support View A and this qualification represents a fairly high hurdle. Similarly, Group members noted that the fact that a bare trust holds just the title to the property and cannot do anything else as an agent is a key fact needed to support View A.

The Group agreed that this relatively simple fact pattern involving only a bare trust should not be brought to the attention of the IFRS Interpretations Committee by the AcSB because diversity in practice is not expected to emerge. However, some Group members noted that a bare trust

typically is used to hold only the property, and another separate vehicle (such as a corporation or partnership) is used to hold other assets and liabilities of the joint arrangement. When a joint arrangement involves more than one separate vehicle, classification of the joint arrangement is more problematic. The Group recommended that the AcSB should bring this more complex fact pattern to the attention of the IASB or IFRS Interpretations Committee because diverse views appear to exist and as a result, diversity in practice is expected to emerge.

IFRS 11: Application Issues

IFRS 11 *Joint Arrangements* requires an entity to classify a joint arrangement as a "joint operation" or a "joint venture". This classification is important because the accounting treatment depends on the type of joint arrangement.

A number of questions have arisen about how to apply IFRS 11 to various arrangements and whether the classification of an arrangement under IFRS 11 as a joint operation or a joint venture should be affected by how the arrangement is structured.

Fact Pattern 1 with 2 Possible Structures
A manufacturing facility is jointly controlled by two parties: A Ltd. and B Ltd. The arrangement could be structured so that:

1. A Ltd. and B Ltd. each hold their undivided interest in the manufacturing facility through single purpose holding companies; or
2. A Ltd. and B Ltd. hold the manufacturing plant through a single legal entity.

The first issue considered by the Group was whether the arrangement should be consistently classified as a joint operation or a joint venture for both structures. Specifically, does IFRS 11 apply narrowly to the joint arrangement in the context of the individual entities holding the interest in the joint arrangement (*View A*) or does it apply to the arrangement in the context of the group as a whole (*View B*)?

View A – IFRS 11 applies narrowly and each structure has a different accounting treatment
Proponents of this view argue that structure 1 qualifies as a joint operation because the joint arrangement held by the holding companies is not structured through a separate legal entity. However, structure 2 qualifies as a joint venture.

View B – IFRS 11 applies broadly and both structures have the same accounting treatment
Proponents of this view argue that IFRS 11 applies to the arrangement in the context of the group as a whole. Since from a group perspective, A Ltd. and B Ltd. have substantially isolated themselves from the plant in a manner equivalent to holding the plant through a single legal entity, the arrangement should be consistently classified as a joint venture for both structures.

Fact Pattern 2 with 6 Possible Structures
Certain commodities are readily saleable in a highly liquid market (for example, crude oil or gold) and sold almost immediately upon production. Often, facilities to produce these

commodities are held through undivided interests but, in some cases, they may be structured through partnerships, corporations or other legal entities.

X Ltd. and Y Ltd. have an interest in Oil LP, a limited partnership arrangement owning an oil well, whose production is sold immediately at spot price upon extraction to a single party (i.e., at the wellhead). The partnership has no debt other than minimal trade payables to suppliers.

The arrangement could be structured through different contractual terms, including the following six possibilities:

1. The partners take production as principal and sell the production on their own behalf, paying production costs in proportion to their ownership interests to Oil LP.
2. Oil LP sells production on its own account and remits net cash flows to X Ltd. and Y Ltd..
3. Oil LP sells production as agent for the partners in proportion to their ownership, remitting the net cash flows after paying production costs to the partners.
4. Oil LP sells production as agent for the partners in proportion to their ownership, receiving a cheque for production costs from the partners and remitting to the partners the cash flows from the sale of the oil.
5. X Ltd. and Y Ltd. act as marketing agents for the partnership and sell production as agents on behalf of the partnership in proportion to their ownership, remitting the cash flows to the partnership and receiving distributions from the partnership net of the production costs.
6. X Ltd. and Y Ltd. act as marketing agents for the partnership and sell production as agents on behalf of the partnership in proportion to their ownership, retaining the cash flows and reimbursing production costs to the partnership.

The second issue considered by the Group was whether the accounting for the joint arrangement differs in these six scenarios. Specifically, when the legal form and contractual arrangements confer legal separation between the entity and a joint arrangement, does IFRS 11 require legal title or other ownership to be taken of the output of a joint arrangement to classify the arrangement as a joint operation, particularly when the output is a highly liquid commodity?

The Group's Discussion

In discussing the first fact pattern involving two possible structures involving A Ltd. and B Ltd., Group members expressed support for View A, noting that an entity cannot override IFRS 11 through some notion of substance. However, Group members expressed concern that IFRS 11 gives rise to such structuring opportunities.

Group members noted that IFRS 11 reads like a form-based standard rather than a substance-based standard. Group members observed that one of the main criticisms of the old standard, IAS 31 *Interests in Joint Ventures*, is that it was a form-based standard. Members noted that the form of an arrangement (i.e., the existence of a separate legal entity) can speak volumes about the substance of the arrangement (i.e., the rights and obligations of a party to a joint arrangement). The guidance in IFRS 11 that focuses on the form of the arrangement may be

intended to highlight that the rights and obligations in a joint arrangement depend, in part, on the existence of a separate legal structure. As a result, the form of the arrangement should not be ignored when classifying the arrangement.

In discussing the second fact pattern involving six possible structures for X Ltd. and Y Ltd.'s interest in Oil LP, Group members observed that paragraph B14 in IFRS 11 is relevant:

> "The classification of joint arrangements required by this IFRS depends upon the parties' rights and obligations arising from the arrangement in the normal course of business. This IFRS classifies joint arrangements as either joint operations or joint ventures. When an entity has rights to the assets, and obligations for the liabilities, relating to the arrangement, the arrangement is a joint operation. When an entity has rights to the net assets of the arrangement, the arrangement is a joint venture. Paragraphs B16-B33 set out the assessment an entity carries out to determine whether it has an interest in a joint operation or an interest in a joint venture."

Group members observed that the element in IFRS 11 causing concern is the guidance in paragraph B15(b)(iii) that an entity shall consider "when relevant, other facts and circumstances" when assessing the rights and obligations arising from the arrangement. In addition, Group members observed that paragraphs B29-B32 in IFRS 11 provide further guidance for assessing these other facts and circumstances, including Example 5 in paragraph B32.

Group members observed that structures 1, 3 and 4 in the second fact pattern are the more obvious candidates for joint operation treatment because the output is being taken by the partners and the presumption that the arrangement is a joint venture is overcome, consistent with Example 5 in paragraph B32 of IFRS 11. However, further analysis would be necessary before being able to conclude that joint operation treatment is appropriate in these circumstances.

In contrast, Group members observed that structures 2, 5 and 6 are quite different and that additional nuances exist when comparing structure 2 to structures 5 and 6. While a possible perspective is that these structures can be assessed in the context of the net cash flows received by the holding company (i.e., X Ltd. or Y Ltd.), Group members disagreed with this approach. They noted that having two structures with the same net cash flows at the holding company level does not mean that the two structures should be accounted for in the same way. Instead, it is necessary to focus on where rights to the assets and obligations for the liabilities of the arrangement exist.

The Group agreed that this issue should not be brought to the attention of the IFRS Interpretations Committee.

Paul Cherry, Chair of the IFRS Advisory Council, noted that the IFRS Foundation Trustees' Due Process Oversight Committee considered a complaint recently that the IASB did not follow its due process. The complaint noted that the IASB added the requirement in paragraph B15(b)(iii)

(i.e., that an entity shall consider "when relevant, other facts and circumstances") and other application guidance including Example 5 in paragraph B32 relatively late in the process. The complaint argued that this guidance represented a substantive change for which sufficient input from stakeholders was not obtained. The Due Process Oversight Committee's response includes the IASB staff report that discusses this requirement and guidance on pages 2-4.

IAS 1: Classification of Long-term Debt to Be Repaid from an Offering

An entity may raise funds through a public offering. In the offering document the entity discloses that it expects to use the proceeds from the offering to settle a long-term debt obligation. The long-term debt is not part of the working capital used in the entity's normal operating cycle and is not otherwise due within twelve months of the reporting date.

As the long-term debt is now expected to be settled within twelve months, does paragraph 69(a) of IAS 1 *Presentation of Financial Statements* require the entity to reclassify the debt as a current liability (*View A*) or continue classifying the debt as a long-term liability (*View B*)?

View A – Reclassify the debt as a current liability

Proponents of this view argue that paragraph 69(a) of IAS 1 is clear that an entity is required to classify a liability as current when "it expects to settle the liability in its normal operating cycle" noting that paragraph 70 of IAS 1 states, in part, "when the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months."

Further, proponents of this view note that paragraph 72(a) of IAS 1 states that "an entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if (a) the original term was for a period longer than twelve months." As a result, proponents of this view argue that a focussed read of paragraph 69(a) of IAS 1 requires an entity that expects to settle a long-term debt within twelve months, to reclassify the debt as a current liability.

View B – Continue classifying the debt as a long-term liability

Proponents of this view argue that paragraph 69(a) of IAS 1 is intended to address current liabilities as described in paragraph 70 of IAS 1, which states, in part, that:

> "Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period. The same normal operating cycle applies to the classification of an entity's assets and liabilities."

Proponents of this view argue that paragraph 69(a) of IAS 1 is not intended to address long-term liabilities that are not otherwise due, but that may be settled at the discretion of management

within the entity's normal operating cycle. This conclusion is consistent with paragraph 71 of IAS 1, which states, in part, that:

> "Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities, subject to paragraphs 74 and 75."

Paragraphs 74 and 75 of IAS 1 provide guidance regarding classification when an entity breaches a covenant of a long-term debt.

Proponents of this view also look to paragraph 62 of IAS 1, which explains the requirement to present current and non-current items separately, observing that:

> "When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities in the statement of financial position provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations."

Therefore, proponents of this view argue that when an entity's debt is not circulating as working capital and is not otherwise due for settlement in the entity's normal operating cycle, the debt should not be reclassified as a current liability.

The Group's Discussion

Most Group members supported View B while others accepted either view, depending on the facts and circumstances. In addition, some Group members preferred View A when considering certain fact patterns. Group members discussed their reasoning and expressed concern with any diversity in views in this area.

Group members observed that the relevant paragraphs in IAS 1 are not very clear and become even less clear when applied to different scenarios. Some Group members observed that the application of View A to some circumstances may create illogical consequences and result in inappropriate financial reporting outcomes. For example, classifying the debt as current could trigger a covenant violation, and this outcome would likely be illogical because the entity is presumably becoming better off rather than worse off. Other Group members observed that View B may be difficult to support under other fact patterns. For example, when the financing deal is complete or virtually complete at the reporting date and a few days after the end of the reporting period the entity receives the proceeds and repays the liability. However, other Group members expressed concern that this approach seems inconsistent with the presentation in reverse situations. For example, when an entity refinances debt or obtains a waiver for a covenant violation after the reporting date.

Group members observed that there is tension in IAS 1 over whether the core principle is based on an item being part of working capital or the timing of required cash flows. Group members observed that this tension gives rise to both views having some technical merit and it would be helpful to have clarity over which principle in the standard prevails. Also, Group members noted that the notion that the debt would not be settled out of current assets represents an ingrained concept in U.S. GAAP that is missing from IFRSs and perhaps should be considered.

Group members supported a recommendation to refer this issue to the IFRS Interpretations Committee noting that there is a lack of clarity and inherent inconsistency in the key paragraphs in IAS 1 relevant to this issue. Group members suggested that this issue could be raised via several different channels, including comment letters on the IASB's Exposure Draft, "Annual Improvements to IFRSs 2010–2012 Cycle," on the classification of liabilities relating to refinancing provisions.

Although some Group members questioned whether significant diversity in practice exists, others noted that any diversity emerging in practice is troubling. Also, Group members expressed discomfort with the idea that an entity could have the ability to choose between the two views in some circumstances.

The Group recommended that the AcSB should bring this issue to the attention of the IFRS Interpretations Committee because there is a lack of clarity under IAS 1 over whether View A could be, should be, or must be applied.

IAS 8: IFRSs Issued but not yet Effective

Canadian entities that prepare financial statements in accordance with IFRSs as issued by the IASB and in accordance with Canadian GAAP (i.e., Part I of the CICA Handbook – Accounting) need to:

- decide whether to apply any new or amended IFRSs before the mandatory effective date, when that is permitted; and
- determine what disclosures are required under paragraph 30 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* about IFRSs issued but not yet effective and not yet applied by the entity.

A time lag occurs between the issuance of a new or amended IFRS by the IASB, its approval by the AcSB and its publication in the Handbook. For example, the amendments to IAS 32 *Financial Instruments: Presentation* and IFRS 7 *Financial Instruments: Disclosures* on offsetting of financial instruments were issued in December 2011 by the IASB, approved by the AcSB in March 2012, and published in the Handbook in May 2012.

An entity that issued its annual financial statements at the end of February 2012 may have questioned whether to disclose these amendments as issued but not yet effective and not yet

applied or whether it can apply the amendments early and still state compliance with Canadian GAAP.

In May 2012, the IASB issued *Annual Improvements 2009–2011 Cycle*, which clarifies a number of IFRSs. All amendments are required to be applied to annual periods beginning on or after January 1, 2013 and all permit earlier application. The *Annual Improvements 2009–2011 Cycle* was approved by the AcSB in June 2012 and will be issued in the Handbook in August 2012.

The issue considered by the Group was at what point do new or amended IFRSs become part of Canadian GAAP. Specifically, if an entity prepares financial statements in accordance with Part I of the Handbook, when should the entity disclose information about a new or amended IFRS not yet effective and not yet adopted under paragraph 30 of IAS 8, and when can this entity choose to early adopt a new or amended IFRS that permits earlier application but is not yet effective?

View A – When the IASB has issued the new or amended IFRS

View B – When the AcSB has approved the new or amended IFRS

View C – When the AcSB has issued the new or amended IFRS in the Handbook

The Group's Discussion

Several Group members noted that they had not previously considered this issue but thought that a new or amended IFRS was eligible for early application once the IASB issued the new or amended IFRS based on the existing language in the Introduction to Part I of the Handbook. Group members observed that most do not choose to apply a new or amended IFRS early, perhaps with the exception of narrow scope amendments such as annual improvements.

Gord Fowler, Chair of the AcSB, clarified that a new or amended IFRS becomes part of Canadian GAAP only after the AcSB has issued the new or amended IFRS in the Handbook in both official languages (i.e., View C). Mr. Fowler noted that the time lag between the IASB and the AcSB issuing a new or amended IFRS is relatively short and any jurisdiction that endorses IFRSs experiences such a delay. In addition, under paragraph 3.2(1) of National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards,* a reporting issuer needs to be in compliance with both Canadian GAAP and IFRSs as issued by IASB.

Some Group members noted that, read literally, paragraph 30 of IAS 8 requires disclosure of new or amended IFRSs issued by the IASB but not yet applied, regardless of whether the AcSB has incorporated the changes into the Handbook. However, by the time an entity must file its first set of financial statements following the IASB's issuance of a new or amended standard, that standard would often have been incorporated into the Handbook. When that is not the case, some may consider that the existing disclosure requirement in paragraph 30 of IAS 8 that is within the Handbook does not extend to new requirements that are not yet in the Handbook.

However, to comply with paragraph 3.2(1) of National Instrument 52-107 and paragraph 16 of IAS 1, an entity would need to provide the disclosures set out in paragraph 30 of IAS 8 and would generally be able to do so.

In light of this information, Group members observed that entities can comply with both IFRSs as issued by the IASB and Canadian GAAP by:

- voluntarily providing the disclosures under paragraph 30 of IAS 8 for a new or amended IFRS issued by the IASB that has not been incorporated into the Handbook; and
- choosing to wait to apply a new or amended IFRS until it is incorporated into the authorized (i.e., electronic) version of the Handbook.

If a reporting issuer wishes to apply a new or amended IFRS before it is included in the Handbook, the issuer could apply for exemptive relief from the Canadian Securities Administrators.

The Group recommended that the AcSB should consider including guidance in the Handbook to clarify this issue.

IAS 39: Implications on Hedging Relationships of Novation of Derivatives

Globally, there is a push to require financial institutions to enter into derivatives that are cleared through derivative-clearing organizations rather than continuing with over-the-counter (OTC) or bilateral trades. This push is intended to eliminate counterparty credit risks that are inherent when two counterparties enter into a derivative such as an interest rate swap.

This push raises questions about the potential implications on pre-existing hedging relationships for certain financial institutions when a derivative contract in a valid hedging relationship is required by regulation to be "novated" and transferred to a central clearing house for settlement.

Fact Pattern

- Bank A and Bank B enter into an interest rate swap in which Bank A agrees to pay Bank B a variable rate, and Bank B agrees to pay Bank A a fixed rate. As result, Bank A is exposed to Bank B's credit risk and vice versa.
- Bank A and Bank B are required to clear the derivative through a clearing organization. As a result, each of Bank A's and Bank B's credit risk exposure is replaced with that of the clearing organization.
- Interposition of a clearing organization results in novation of the over-the-counter derivatives and the central counterparty (i.e., a clearing organization) becomes the new counterparty to each of the original parties via two new contracts. As a result, Bank B is no longer the counterparty to Bank A and vice versa. The clearing organization becomes each of Bank A's and Bank B's counterparty.

The issue considered by the Group was whether hedge accounting under IFRSs should be terminated (*View A*) or can be continued (*View B*) if a derivative that is designated as a hedging instrument is novated to a different counterparty when all other terms and conditions of the original derivative remain the same.

View A – Hedge accounting should be terminated

Proponents of this view argue that a critical term of a hedging derivative is its counterparty. Regardless of which risk is designated as the hedged risk in a qualifying hedging relationship, the assessment and measurement of effectiveness and ineffectiveness, respectively, is driven partially by counterparty credit risk. If a counterparty to a hedging derivative changes, it necessitates a change in counterparty credit risk (even when the ratings of the original and replacement counterparties may be the same). As a result, proponents of this view argue that hedge accounting should be terminated.

View B – Hedge accounting can be continued

Proponents of this view argue that a framework exists within IAS 39 *Financial Instruments: Recognition and Measurement* that doesn't require dedesignation and, as a result, novation does not cause termination of hedge accounting. If fully collateralized, novation does not represent a substantive change if the hedge remains effective. Further, IAS 39 does not explicitly state that a change in counterparty causes dedesignation. As a result, proponents of this view argue that if the change in credit risk does not affect hedge effectiveness, hedge accounting should be continued.

The Group's Discussion

The Group observed that the International Swaps and Derivatives Association, Inc. had requested that the U.S. Securities and Exchanges Commission (SEC) staff address this issue under U.S. GAAP. The SEC staff recently released a response[1] indicating that it would not object to the continuation of hedge accounting for the existing hedging relationship under certain specified circumstances and when all other terms and conditions remain the same. Group members noted that the International Swaps and Derivatives Association, Inc. may submit a similar request to the IASB.

The Group observed that Canada is not the only country facing this issue, which is being discussed in other jurisdictions including Europe. As a result, the issue is evolving in several arenas and some time is needed to allow the international discussions to play out. Group members observed that any action the AcSB may take should not conflict with or slow down the evolution of the international discussions.

[1] The SEC staff's response is available on the SEC's website at: http://www.sec.gov/info/accountants/staffletters/isda051112.pdf.

Group members expressed concern that if the Dodd-Frank Wall Street Reform and Consumer Protection Act legislation becomes effective later this year, this issue will arise for practically an entire derivatives portfolio rather than just a few isolated transactions. As a result, there is a pressing need to resolve this issue before any significant diversity in practice emerges.

Group members observed that one of the reasons the issue was tabled was to seek Group members' views on whether the AcSB should wait and see what transpires globally or be more proactive and take some more immediate action.

Group members noted that View B is currently not sufficiently developed and needs further articulation prior to raising this issue with the IASB or the IFRS Interpretations Committee. As a result, the Group agreed that there is no immediate action to recommend to the AcSB. However, Canadian stakeholders in the banking industry should consider working to develop and articulate View B sufficiently so that any necessary action can be taken when appropriate.

UPDATE ON PREVIOUS ISSUES THE GROUP RECOMMENDED BE REFERRED TO THE IASB OR THE IFRS INTERPRETATIONS COMMITTEE

IAS 33: Earnings per Share/Unit for Entities with Puttable Equity Instruments

The Report on the Group's Public Meeting for June 16, 2011 noted that the AcSB directed the staff to draft a request for an "Annual Improvement" that would permit instruments that are classified as equity under the exception in IAS 32 to be classified as equity when applying IAS 33 as recommended by the Group. In July 2012, the AcSB decided that this request should not be submitted at this time. Instead, the AcSB directed the staff to monitor practice and to raise the issue again if diversity emerges, or when the IASB decides to conduct a project related to this issue.

IAS 10: Reissuing Financial Statements in Connection with an Offering Document

At the January 2012 meeting, the Group recommended that the AcSB refer to the IFRS Interpretations Committee an issue on the accounting implications of applying IAS 10 *Events after the Reporting Period* when reissuing financial statements in connection with an offering document. In May 2012, the AcSB considered the Group's recommendation and directed the staff to undertake further research and discuss the issue with the staff of the IFRS Interpretations Committee. At a future meeting, the AcSB will consider the results of the staff's work and decide whether to bring this issue to the attention of the IFRS Interpretations Committee, as recommended by the Group.

IFRS 3 and IAS 12: Uncertain Tax Positions Acquired in a Business Combination

At the April 2012 meeting, the Group discussed whether an uncertain income tax position that is acquired through a business combination is subject to the recognition and measurement

exception in IFRS 3 relating to income taxes. In July 2012, the AcSB agreed with the Group's recommendation to refer this issue to the IFRS Interpretations Committee.

UPDATE ON THE IFRS INTERPRETATIONS COMMITTEE'S OUTREACH REQUESTS

The responsibilities of the Group include providing information on requests from the IASB, and national standard setters or similar bodies regarding eligibility of issues for possible action by the IFRS Interpretations Committee.

The AcSB staff circulates many of these outreach requests to Group members to obtain information about the prevalence of the issue in Canada and the level of diversity in practice. Input from Group members or other experts forms the basis for the AcSB staff response to the IFRS Interpretations Committee staff.

Since the Group's April 2012 meeting, the AcSB staff has responded to four outreach requests. The AcSB staff circulated one request to Group members regarding the purchase of a non-controlling interest when the consideration includes non-cash items. The AcSB staff did not circulate the other three requests to Group members. Instead, the AcSB staff obtained input from other individuals with expertise and experience relevant to the specific issues.