IFRS Discussion Group

Report on the Public Meeting

May 30, 2017

The IFRS Discussion Group's purpose is to act in an advisory capacity to assist the Accounting Standards Board (AcSB) in supporting the application in Canada of IFRS® Standards. The Group maintains a public forum at which issues arising from the current application, or future application, of issued IFRS Standards are discussed and makes suggestions to the AcSB to refer particular issues to the International Accounting Standards Board (IASB) or IFRS Interpretations Committee. In addition, the Group provides advice to the AcSB on potential changes to IFRS Standards and such discussions are generally held in private.

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

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

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ITEMS PRESENTED AND DISCUSSED AT THE MAY MEETING

Cap and Trade Program

Many governments around the world have, or are in the process of developing, programs to encourage corporations and individuals to reduce emissions of pollutants. The Government of Ontario introduced a Cap and Trade program as of January 1, 2017 whereby participants are allocated emission rights or allowances equal to a maximum level of allowable emissions. Entities are permitted to trade those allowances.

Below is a brief overview of Ontario's Cap and Trade program:

- The program introduces caps on the amount of greenhouse gas emissions that Ontario's largest polluters may emit, with the cap being lowered over time. Mandatory participants include large final emitters and specified larger natural gas distributers, fuel suppliers, and electricity importers. Voluntary participants may also partake in the program.
- Participants must submit allowances or credits equal to actual emissions for each compliance period. If the emissions exceed the cap, the participant must buy allowances or credits for compliance purposes. Excess allowances and credits can be sold into the market.
- The cap is the maximum number of allowances that the government creates each year. Capped participants can get allowances either through government grants, at a government auction or purchasing from other participants in a secondary market.
- Credits are compliance instruments granted for early reductions or for reductions, removals, or avoidance of carbon dioxide equivalent emissions achieved by those who are not capped participants.
- The program is expected to link with programs in Quebec and California to enable trading of allowances and credits among the three jurisdictions.

To date, there is no specific guidance under IFRS Standards for cap and trade programs. In 2004, the IASB had issued IFRIC 3 *Emission Rights* but due to various concerns, it was withdrawn in 2005. Absent specific guidance, entities have adopted various accounting approaches. The Group discussed three common approaches seen in practice in accounting for transactions arising from cap and trade programs.

Approach 1 – Apply an IFRIC 3 approach.

Cap and trade allowances (i.e., purchased or allocated) are recorded as intangible assets and accounted under IAS 38 *Intangible Assets*. Allocated allowances received are considered government grants and accounted at fair value under the IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* model. The grant is recognized as deferred income and recognized into income on a systematic basis over the compliance period. Purchased allowances are initially measured at cost. If there is an active market, the purchased allowances can be subsequently remeasured at fair value if the entity chooses to apply to the revaluation model in IAS 38. Otherwise, the purchased allowances are carried at cost, subject to impairment if indicators exist.

A liability for the obligation to deliver allowances equal to the emissions produced is accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The liability is measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. This best estimate would usually be at the present market price of the number of allowances required to cover emissions made up to the reporting date.

Approach 2 – Apply net liability approaches.

The asset side of the transaction is similar to Approach 1 except that allocated allowances received are considered non-monetary grants under IAS 20, and therefore, recorded at nominal amount. There are two sub-approaches to consider for the liability side:

- *Net Liability Approach*: IAS 37 requires a provision to be recorded only if there is a present obligation as a result of a past event. Therefore, a provision is recognized when the actual emissions exceed the emission rights granted and held because in this situation, an entity would be required to purchase additional allowances in the market or incur a penalty. The provision is measured by reference to the amount initially recorded for granted rights and purchased rights (if any). The liability for any excess emissions is measured at the lower of the expected cost to purchase additional allowances or the amount of any regulatory penalty.
- *Net Liability/Net Reimbursement Right Approach:* The entity considers the emission rights it purchased and holds as a reimbursement right under IAS 37. The entity would remeasure the emission rights that it purchased and holds to fair value, but the amount is not to exceed the related provision in accordance with paragraph 53 of IAS 37. The provision is measured independently of how the settlement may be funded by the entity, which would be at the fair value of the emission rights in excess of granted rights required to settle the emissions produced.

Approach 3 – Apply a government grant approach.

Similar to the IFRIC 3 approach, emission rights granted by the government are measured initially at fair value with a corresponding government grant in accordance with IAS 20.

On the liability side, rather than measuring the liability for the obligation to deliver allowances at the present market price, the liability is measured by reference to the amounts recorded when the rights were initially granted. To the extent emissions are not covered by emission rights on hand, the excess liability is recognized at the lower of expected costs to purchase additional allowances or the amount of any regulatory penalty.

Similarities across the three approaches include the following:

- Purchased allowances are initially recorded at cost.
- An entity would need to evaluate any intangible asset for impairment. If the market value of emission rights falls below the carrying value, this does not automatically result in an impairment charge as emission rights are likely to be tested for impairment as part of a larger cash-generating unit. This ignores impairment charges that would result from a net decline in emission right market values if the revaluation model under IAS 38 were applied.
- Generally, amortization is not recorded for these cap and trade allowances since these are ultimately exchanged for emissions produced, therefore the depreciable amount is nil.
- A liability is generally recognized as emissions are produced.

The approaches outlined above generally yield the same net profit or loss outcome over the full compliance period, however they can give rise to net profit or loss differences at a point in time during the compliance period. The approaches can also potentially lead to different presentations of asset and liability amounts on the Statement of Financial Position and could also produce different results in a business combination or a sale of emission rights.

There are several views regarding classification. Some think that the allowances are considered intangible assets, while others think that inventory or financial instruments classification could be appropriate based on the intended use of the allowances.

The Group's Discussion

The Group discussed the following three questions on this topic:

1) For Approaches 1 and 3, what is considered an appropriate systematic basis for recognizing the government allocated allowances (i.e., accounted for as a government grant under IAS 20) at fair value into profit or loss?
2) What is meant by net liability when applying the net liability approach?
3) Are entities applying an approach different from what is described under Approaches 1 to 3, and can an accounting approach be mixed or tailored if it better reflects the substance of the transactions arising from the cap and trade program?

For the first question, some entities may recognize the grant into income on a straight-line basis over the compliance period, while others may recognize the grant based on when the allowances are used against the emissions produced. One Group member highlighted that the type of allowance or credit received could influence what is considered an appropriate systematic basis for recognizing the grant. For example, some credits are granted based on capital initiatives undertaken by the entity to reduce emissions produced. Therefore, a systematic basis aligned with the activities undertaken (or capital costs incurred) by the entity may better reflect the substance of the transaction. A straight-line approach or a units of pollutant production approach may be more suitable if the allocated allowance is directly related to the emissions obligation.

The Group also briefly discussed whether there is an active market for cap and trade allowances. Given the limited activity to date in Ontario, it is difficult to determine the fair value of these allowances. One Group member pointed out that the cost approach is generally more attractive to entities, and therefore, this question is often not relevant.

For the second question, several Group members noted that it is important to first determine whether the entity has an asset before considering whether the asset and liability can be netted together. The allowances are like a right for the entity to continue its operations. There is no value to these rights until the emissions produced are less than or exceed the emission rights granted and held. In other words, if an entity anticipates that all granted allowances will be used to satisfy its emission obligation, it may find one of the net liability approaches (in Approach 2) more logical. However, an entity that anticipates being granted excess allowances may find one of the other approaches to have some merit.

One Group member thought these rights share similar attributes to a derivative, a concept not contemplated under IAS 20. In terms of netting the asset and liability, one Group member thought an analogy could be drawn to the net presentation requirements for deferred taxes under IAS 12 *Income Taxes*.

Entities should also consider the consequences of not being able to obtain additional allowances. For example, the allowances enable the entity to continue operating the plant. However, if there are insufficient allowances to offset against the emissions produced and the entity is unable to acquire additional allowances or undertake other actions to constrain the emissions, the plant may not be allowed to continue operating at current capacity.

For the third question, several Group members observed it may be too early to tell what approaches entities have adopted. There does not seem to be a lot of practice questions in this area, possibly due to the fact that Ontario's first compliance period is over four years. One Group member noted that U.S. GAAP had some guidance that considered allowances to be like inventory. The allocated grants are recognized at nil and purchased allowances are recognized at cost. The allowances are measured using a weighted-average cost method, similar to inventory.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 15: Purchase Returns

IFRS 15 *Revenue from Contracts with Customers* provides application guidance for a sale with a right to return (i.e., paragraphs B20 to B27 of IFRS 15). However, the standard or the discussions[1] of the IASB/FASB Joint Transition Resource Group for Revenue Recognition have not specifically addressed a situation when:

- an entity's revenue is constrained to zero (or a minimal amount) due to a customer's ability to return the product for a period of time after the sale; and
- the entity incurs costs to recover products that are returned.

Fact Pattern

- Entity A develops, manufactures and distributes innovative products. Product X was launched in mid-2018 and there is no other similar product on the market.
- On November 30, 2018, Entity A enters into a contract with Entity B (a retail company) to sell 100 units of Product X for $10,000.
- Entity A has a written policy allowing its retail customers to return any unsold products within 90 days. Entity A agrees to pay the shipping costs of any units returned by Entity B and estimates that the cost to ship each unit is $10.
- The cost to produce each unit of Product X is $70 and Entity A thinks that the product can be resold at a profit.
- At Entity A's year end, December 31, 2018, Entity B has not returned any units of Product X. Entity A's financial statements are issued on February 18, 2019.

Issue 1: What factors should Entity A consider when determining the amount of revenue to be recognized at the inception of the contract (i.e., November 30, 2018) and at year end (i.e. December 31, 2018)?

Factors to consider in assessing the constraint on variable consideration include: Product X is a brand new product so there is no sales history, the product is unique on the market, and Entity A has given customers a 90-day return period.

At the inception of the contract, Entity A needs to determine if it can make a reasonable estimate of the amount of variable consideration to which it expects to be entitled. Entity A will then need to consider the constraint on the variable consideration and assess whether it is highly probable that a significant revenue reversal would not occur on any revenue recognized.

At year end, Entity A reassesses whether it can estimate the amount of variable consideration to which it expects to be entitled and the constraint on variable consideration. As the return period is still open, Entity A needs to reconsider the same factors existing at the inception of the contract and any new information received up to year end.

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[1] TRG Agenda Paper 44, Topic 9: Accounting for restocking fees and related costs (TRG Agenda Ref No. 35) does not contemplate a situation when the application of sales with a right of return would result in a complete deferral of revenue recognition and when the entity will incur costs to recover products.

Entity A should also consider if it has effectively given Product X to Entity B for trial or evaluation purposes and whether paragraph B86 of IFRS 15 should be applied. This paragraph provides guidance on customer acceptance whereby an evaluation is made as to whether control of the product has transferred when an entity delivers a product to a customer for trial or evaluation purposes.

The Group's Discussion

The Group welcomed to the discussion the Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition.

Group members agreed that the factors described above were relevant. The Group noted the importance of understanding the facts and circumstances of the situation and of considering other factors, including:

- historical resale data (for example, sales, returns and gross margin of Product X and of similar products) both during the year, and in between the year end and the issuance date of the financial statements;
- the payment terms set out in the contract; and
- any uncertainties associated with the transaction (for example, whether the retailer will be able to sell the product with a margin to another customer and would record the inventory at its net realizable value in accordance with IAS 2 *Inventories*).

The Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition emphasized the importance of thinking about the requirements in IFRS 15 completely differently than those under IAS 18 *Revenue* and the need to go back and read the related contracts in this light. IFRS 15 is a new model with different logic and should be applied by reasoning from its principles.

Issue 2: If control of the product has been transferred to Entity B as of November 30, 2018 (i.e., a sale has occurred) yet Entity A is not able to recognize any revenue at November 30 and December 31, 2018 due to the constraint on the variable consideration, how should Entity A measure the right of recovery asset on those dates?

View A – The right of recovery asset should be measured at the former carrying amount of the product less expected costs to recover.

Proponents of this view note that paragraph B25 of IFRS 15 requires that the right of recovery asset be measured by reference to the former carrying amount of the product (for example, inventory) less any expected costs to recover those products. The expected costs would include both actual costs incurred (i.e., shipping costs) and potential decreases in the value of the returned products.

On November 30, 2018, Entity A recognizes a right of recovery asset for all units sold to Entity B. The right of recovery asset is measured at $6,000 [($70 cost - $10 shipping) x 100 units]. Although Entity A cannot record any revenue on the sale of 100 units of Product X to Entity B at inception, it is still required to record a cost of recovery expense of $1,000 that represents the shipping costs for all products that could potentially be returned. The cost of recovery expense will be adjusted when

Entity A is able to more accurately estimate the number of products returned and the actual shipping costs incurred.

On December 31, 2018, no additional entries are made because revenue is still constrained to zero and the right of recovery asset must still reflect the potential return of all units sold.

View B – The right of recovery asset should be measured at the former carrying amount of the product with no deduction for expected costs to recover.

Proponents of this view think View A does not reflect the substance of the arrangement. A negative margin is created by recognizing an expense relating to future costs that have not yet been incurred when no revenue is recognized.

Given that Entity A cannot estimate the transaction price to be received, Entity A is also not able to reasonably estimate the amount of shipping costs that it will incur. Therefore, at November 30, 2018, the right of recovery asset should be measured at $7,000 (i.e., the former carrying amount of the inventory). Shipping expense should be recognized when Entity A is able to reasonably estimate the cost to recover.

On December 31, 2018, no additional entries would be recorded for the same reason as in View A.

The Group's Discussion

The Group noted that the most important first step was to determine the facts and circumstances of the transaction by reviewing the terms of the contract. The Group acknowledged that the legal terms in the contract may not be determinative and therefore, emphasized the importance of considering the substance of the transaction.

Most Group members supported View A as the technically correct view based on the guidance in paragraph B25 of IFRS 15. However, some members had difficulty conceptually with the conclusion that Entity A could not record any revenue at the inception of the contract with Entity B to sell Product X, but was required to record any expected costs to recover that product.

A few Group members also reconsidered the initial assumption of whether control of the product has truly been transferred to Entity B. Within this context, a different view predicated on the customer acceptance guidance in paragraph B86 of IFRS 15 was expressed. They thought that Product X may have been given to Entity B for trial or evaluation purposes. As such, rather than concluding that control of the product has been transferred to Entity B and recording a sale with a right of return, no sale has actually occurred on November 30, 2018 and Entity A continues to reflect Product X in its inventory.

The Group noted an entity needs to consider the specific facts and circumstances of the arrangement to determine whether the "trial or evaluation" or "right of return" provisions of IFRS 15 apply.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 9, IFRS 15 and IAS 16: Seller's Right to Variable Consideration in an Asset Sale

At its September 11, 2014 meeting, the Group discussed "IFRS 3, IFRS 15, IAS 18 and IAS 37: Contingent Consideration in an Asset Sale" which focused mainly on the recognition and measurement of contingent consideration.

In this meeting's discussion, the Group will consider the same fact pattern with some added details, taking into account the timing of derecognition, initial recognition and measurement of variable consideration, related balance sheet accounting, and subsequent accounting with respect to IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments*.

Fact Pattern

Entity A sells one or more assets that do not constitute a business to Entity B. The assets are property, plant and equipment that will be accounted for in accordance with IAS 16 *Property, Plant and Equipment.* Entity B pays Entity A cash consideration at the time of the purchase and agrees to pay additional amounts in one year's time based on a combination of factors, including whether Entity B is able to achieve specified production milestones with the assets. Entity A is not in the business of selling items of property, plant and equipment (i.e., this transaction is not in the normal course of business). Entity A has no further performance obligations once the transfer of title and delivery has occurred.

The nature of the variable consideration in this transaction does not give rise to an embedded derivative (i.e., it is based on Entity B obtaining production of 100 units). The variable consideration is due in one year's time; therefore, no significant financing component is identified. The disposal is not a sale and leaseback transaction.

Issue 1: Is the timing of derecognition of property, plant and equipment different under IFRS 15 compared to IAS 18* Revenue*?

IAS 16 requires that the gain or loss arising from derecognition of an item of property, plant and equipment is included in profit or loss when the item is derecognized. It also requires the criteria in IAS 18 to be applied for recognizing revenue from the sale of goods.

Paragraph 14 of IAS 18 provides conditions that have to be satisfied for the recognition of revenue (i.e., the date of derecognition for the asset). For example, an entity needs to assess when the significant risks and rewards of ownership have transferred, determine if it retains continuing managerial involvement in the asset, and assess whether the sale proceeds can be measured reliably. Upon transition to IFRS 15, this cross-reference to IAS 18 in IAS 16 changes to IFRS 15, and therefore, focuses on the notion of control.

Control refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. The notion of continuing managerial involvement does not exist in IFRS 15, at least in terms of assessing when control transfers. The control model in IFRS 15 may affect the timing of derecognition of the asset compared to the risks-and-rewards model in IAS 18.

The Group's Discussion

The Group welcomed to the discussion the Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition.

Group members agreed that in some situations applying the concept of control under IFRS 15, instead of the concept of significant risks and rewards of ownership under IAS 18, could lead to different timing of derecognition of property, plant and equipment. This result may be a lesser known consequence arising upon application of the new standard.

Issue 2: If the criteria for derecognition of property, plant and equipment are met, how should Entity A (i.e., the seller) initially measure the consideration received (or receivable) to determine the gain or loss on sale?

View 2A – The seller's right to variable consideration should be measured with reference to the IFRS 15 guidance on the transaction price and recognized as part of the proceeds on sale of the asset on transfer of control.

Prior to IFRS 15, paragraph 72 of IAS 16 indicates that consideration receivable on the disposal of an item of property, plant and equipment is recognized at fair value. Under IFRS 15, paragraph 72 of IAS 16 is amended to state that the consideration is determined in accordance with the requirements for determining the transaction price in paragraphs 47 to 72 of IFRS 15.

Paragraph 56 of IFRS 15 requires the transaction price to include some or all of an amount of variable consideration estimated in accordance with paragraph 53 of IFRS 15. The inclusion of variable consideration occurs if it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved (i.e., the variable consideration constraint). The assessment is updated at each reporting period.

If the consideration is variable, an entity must estimate the amount using either the "expected value" or "most likely method" under IFRS 15. An inability or difficulty in measuring the transaction price due to variability is not a reason to not recognize revenue. A certain amount of variable consideration may be estimated in the transaction price, subject to the constraint requirement.

In contrast to IAS 18, the constraint requirement in IFRS 15 may result in the consideration initially being measured at an amount lower than fair value, resulting in a corresponding decrease in any gain (or increase in loss). However, if an entity did not previously recognize variable consideration until the contingencies were resolved, the introduction of IFRS 15 could result in an increase in the transaction price and a higher gain on sale (or decreased loss). There could be a transition adjustment on the adoption of IFRS 15 if the contingencies have not been resolved.

View 2B – The seller's right to variable consideration should be recognized and measured at some other point (for example, when the conditions associated with the variability are met and amounts are receivable).

This view is consistent with View B in the Group's September 11, 2014 discussion on the issue "IFRS 3, IFRS 15, IAS 18 and IAS 37: Contingent Consideration in an Asset Sale." That is, variable

consideration is similar to a contingent asset, which should not be recognized in accordance with paragraph 31 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

In addition, in 2013, the IASB considered an IFRS Interpretations Committee paper titled "Variable Payments for the Separate Acquisition of Property, Plant and Equipment and Intangible Assets." Two alternatives were put forward in that paper. One alternative was similar to View 2A above, but contemplated from a buyer's perspective. The other alternative held that contingent consideration payments that are dependent on actions of the buyer do not meet the definition of a financial liability until those actions are performed. Proponents of View 2B may analogize to the latter alternative and conclude that if the buyer does not have a liability, then the seller does not have an asset. However, in March 2016, the IFRS Interpretations Committee observed significant diversity in practice in the accounting for variable payments by the purchaser and determined that the issue was too broad for it to address within the confines of existing standards.

The Group's Discussion

Group members supported that the seller's right to variable consideration should be measured with reference to the IFRS 15 guidance on the transaction price and recognized as part of the proceeds on sale of the asset on transfer of control (View 2A). They noted the importance of using professional judgment to apply the estimation techniques in IFRS 15 to determine the amount of variable consideration.

One Group member also emphasized the importance of considering the type of variability relating to the consideration. Another Group member observed that, as a means to strike an agreement, an entity often promises consideration in a contract with a customer that can vary if the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.

One Group member noted the variability in IFRS 15 is associated with the seller's performance (i.e., a performance or incentive bonus), the quality of goods that have been sold (i.e., the goods performing as promised) or possible actions by the buyer (i.e., returns). Therefore, this Group member thought that it was important to determine whether the variability associated with this issue is the type contemplated within the scope of IFRS 15. This Group member also questioned whether, upon transition, the practical expedient in paragraph C5(a)(ii) of IFRS 15 for completed contracts would be available for contracts when control had transferred and the variable consideration remains unresolved at the date of initial application of IFRS 15.

Issue 3: If the criteria for derecognition of property, plant and equipment are met and the transaction price (proceeds on sale) includes variable consideration (i.e., View 2A), what should Entity A initially recognize in the Statement of Financial Position?

View 3A – The variable consideration is recognized as a contract asset and is initially measured in accordance with IFRS 15.

When an entity satisfies its performance obligation before receiving payment, the entity has a contract asset. IFRS 15 defines a contract asset as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time.

Proponents of this view look to paragraph BC323 in the Basis for Conclusions on IFRS 15, which states, in part, the following:

> "In many cases, that contract asset is an unconditional right to consideration—a receivable—because only the passage of time is required before payment of that consideration is due. However, in other cases, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. The boards decided that when an entity satisfies a performance obligation but does not have an unconditional right to consideration, an entity should recognise a contract asset in accordance with IFRS 15."

Entity A has transferred control of the property, plant and equipment but there is no unconditional right to the variable consideration because Entity B must meet production milestones. The variable consideration is initially recognized at the amount determined in accordance with IFRS 15 because paragraph 2.1(j) of IFRS 9 excludes contract assets from its scope.

View 3B – The variable consideration is recognized as a financial asset (i.e., receivable) and is initially measured in accordance with IFRS 9.

Paragraph AG8 of IAS 32 *Financial Instruments: Presentation* indicates that a contingent right meets the definition of a financial asset, even though such assets are not always recognized in the financial statements.

As the financial asset is initially measured at fair value in accordance with paragraph 5.1.1 of IFRS 9, a day 1 gain or loss would arise on the recognition of the variable consideration. The reason is that the transaction price is determined under IFRS 15, which may not be representative of fair value due to the variable consideration constraint. Paragraph B5.1.2A of IFRS 9 provides guidance on whether the day 1 gain or loss should be recognized immediately into profit or loss.

The Group's Discussion

Group members supported recognizing the variable consideration as a contract asset that is initially measured in accordance with IFRS 15 (View 3A). One Group member noted that once a transaction with a customer is considered to give rise to a contract asset, the contract asset remains until the uncertainty is resolved.

Issue 4(a): If Entity A has initially recognized an amount for variable consideration as a contract asset (i.e., View 3A), how should Entity A subsequently measure the variable consideration?

Paragraph 72 of IAS 16 (as amended by IFRS 15) explicitly states that subsequent changes to the estimated amount of the consideration included in the gain or loss shall be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15.

Paragraph 59 of IFRS 15 requires an entity to reassess, at the end of each reporting period, the estimate of the transaction price, including a reassessment of whether an estimate of variable consideration is constrained. The changes in transaction price are recognized in accordance with paragraphs 87 to 89 of IFRS 15 in the period in which the transaction price changes.

The contract asset would be subject to impairment requirements of IFRS 9 based on paragraph 107 of IFRS 15.

Once Entity A has an unconditional right to consideration, it should present that right as a receivable separately from the contract asset and account for it in accordance with IFRS 9. Entity A would have an unconditional right once Entity B meets all of the production milestones. At this point, Entity A would derecognize the contract asset and recognize a financial asset.

Paragraph 108 of IFRS 15 states, in part, that "upon initial recognition of a receivable from a contract with a customer, any difference between the measurement of the receivable in accordance with IFRS 9 and the corresponding amount of revenue recognised shall be presented as an expense (for example, as an impairment loss)."

Issue 4(b): If Entity A has initially recognized an amount for variable consideration as a financial asset (i.e., View 3B), how should Entity A subsequently measure the receivable?

Subsequent accounting for the variable consideration is in accordance with IFRS 9 because it is viewed as a financial asset.

Assuming that the business model of Entity A is "held-to-collect", the entity would need to assess whether the contingent receivable's contractual cash flows are solely principal and interest. For an instrument to meet the solely principal and interest criterion, the guidance in paragraphs 4.1.2(b) and B4.1.7A of IFRS 9 should be considered. Furthermore, paragraph B4.1.10 of IFRS 9 states, in part, the following:

> "If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator."

Paragraph B4.1.18 of IFRS 9 also provides guidance on when contractual terms can be ignored for classification.

If the solely principal and interest criterion is not met, Entity A is required to measure the variable consideration at fair value. The nature of the contingencies may be a determining factor in whether the solely principal and interest criterion is met and whether the asset is subsequently measured at amortized cost or fair value. The guidance in IFRS 3 *Business Combinations* which requires contingent consideration to be measured at fair value may also be considered.

The Group's Discussion

The Group considered both Issues 4(a) and 4(b) together.

Group members supported the subsequent accounting treatment of the variable consideration as described under Issue 4(a).

The Group did not further contemplate the subsequent accounting treatment under Issue 4(b) given that for this fact pattern, the Group's view is the variable consideration should be accounted for as a contract asset (i.e., View 3A).

The Canadian member of the IASB/FASB Joint Transition Resource Group for Revenue Recognition emphasized the importance of using the terminology inherent in IFRS 15 in discussing issues about revenue (for example, referring to variable consideration, rather than contingent consideration). She explained that the new model in IFRS 15 requires completely different thinking than under IAS 18.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 16 and IAS 34: Variable Lease Payments

Paragraph 38(b) of IFRS 16 *Leases* and paragraph B7 of IAS 34 *Interim Financial Reporting* both refer to variable lease payments.

Paragraph 38 of IFRS 16 states:

> "After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:
>
> (a) interest on the lease liability; and
>
> (b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs."

However, paragraph B7 of IAS 34 states:

> "Variable lease payments based on sales can be an example of a legal or constructive obligation that is recognized as a liability. If a lease provides for variable payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment."

Issue: When is the variable lease payment required to be expensed and included in the lease liability in the following two fact patterns?

Fact Pattern 1

An entity leases an asset for one year and has not elected the short-term lease exemption for that class of assets. Under the terms of the one-year lease, the lessee is required to make an additional payment of $100,000 at the end of the lease on December 31 if its sales for the year exceed $1 million. At inception, the lessee estimates that its sales will exceed the threshold during the year

and therefore expects that the extra amount will be payable at December 31. The $1 million sales threshold is exceeded on September 15.

The two views under this fact pattern are as follows:

- View A – In the first quarter of the year as supported by IAS 34.
- View B – In the third quarter of the year as supported by IFRS 16.

Fact Pattern 2

Under the terms of a four-year lease, the lessee is required to make an additional payment of $100,000 on June 30 of the fourth year if its cumulative sales in the first three years exceed $3 million. At inception, the lessee estimates that its sales will exceed the threshold sometime during the first three years and therefore the extra amount will be payable.

In the first quarter of year 3, the lessee concludes that it is highly probable that the threshold will be met that year given the cumulative results in years 1 and 2, and the backlog of orders for year 3 production. The $3 million cumulative sales threshold is actually exceeded on September 15 in year 3.

The three views under this fact pattern are as follows:

- View A – In the first quarter of year 1 as supported by IAS 34. This view is based on the expectation at inception that the threshold will be achieved at some point during the first three years.
- View B – In the first quarter of year 3 as supported by IAS 34. This view is based on the expectation that the threshold will be met that year, whereas in earlier periods it was unclear when it would be met, and the higher level of probability.
- View C – In the third quarter of year 3 as supported by IFRS 16.

The Group's Discussion

The Group considered both fact patterns together. Group members agreed that there is tension between IFRS 16 and IAS 34 because of the explicit requirement in paragraph 38(b) of IFRS 16.

The Group noted that the application of IFRS 16 should not be affected by the requirements in IAS 34 as the latter is a standard for preparing interim financial statements. IFRS 16 is clear that variable lease payments are recognized in the annual period in which the triggering event or condition occurs. However, there is insufficient application guidance in IAS 34 (i.e., there is very little guidance that tells an entity how best to attribute the payments across the interim reporting periods).

The Group also considered whether the tension exists between IAS 34 and the current lease standard, IAS 17 *Leases*. The Group noted that IAS 17 does not have a similar requirement to what is explicitly stated in paragraph 38(b) of IFRS 16 and observed that preparers tend to follow the illustrative example accompanying IAS 34 (i.e., paragraph B7). However, one Group member noted that there seems to be an internal conflict within the requirements in IAS 34 and this illustrative

example. In particular, paragraph 39 of IAS 34 states "costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year."

Group members observed that this issue highlights the shortcomings of IAS 34 as opposed to a problem with IFRS 16. Given the clear requirements in IFRS 16, the challenge is how to integrate those requirements with the interim reporting model.

As there is potential for diversity in practice, the Group recommended that the issue be discussed with the AcSB to determine whether it should be raised to the IASB or IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 16: Easements

Easements and right-of-way can take many different forms such as being perpetual or time based. Easements can also be subject to different rights and conditions (for example, transportation infrastructure can run over or under a farmer's fields).

Paragraph BC78 in the Basis for Conclusions on IFRS 16 *Leases* indicates that the IASB decided not to specifically exclude long-term leases of land from the standard. However, paragraph 3 of IFRS 16 indicates that rights held by a lessee under licensing agreements are within the scope of IAS 38 *Intangible Assets*.

Questions have arisen around whether easements are within the scope of IFRS 16 and what is the appropriate unit of account for the right to use a defined space.

Fact Pattern

- *Example A*: A leased warehouse is situated on land that is also subject to a right to use agreement for the land. The lessee does not obtain ownership or title to the underlying land and must make payment to the landowner for the use of the land each year.
- *Example B:* A pipeline runs under a farmer's field. The pipeline entity has a right-of-way to access the property for building and maintaining the pipeline. The farmer can continue to utilize the land above the pipeline for growing crops but cannot build any structures on the land over the pipeline.

Some entities may choose to apply IFRS 16 to leases of intangible assets based on paragraph 4 of IFRS 16. However, this policy choice is not further considered in the discussion of the issue below.

Issue: Are easements within the scope of IFRS 16?

View A – Yes, easements are within the scope of IFRS 16.

Proponents of this view note that easements are rights to use land. The IASB specifically decided not to exclude long-term land rights from the scope of IFRS 16. The appropriate unit of account is the defined space utilized by the building or the pipeline.

The scope exemptions for IAS 38 are not automatically applied to easements. Entities need to consider the underlying terms and conditions of the arrangement.

View B – No, easements are considered licensing agreements that are within the scope of IAS 38.

Proponents of this view note that easements have historically been viewed to be within the scope of IAS 38. The issuance of IFRS 16 is not seen to have an effect on previous conclusions.

Easements are only the right to use a portion of land, therefore, guidance on long-term land rights is not applicable.

View C – It depends.

The rights provided by the easements need to be assessed against the definition of a lease in IFRS 16.

Example A appears to meet the definition of a lease because the arrangement conveys a right to control the use of the land for a period of time in exchange for consideration. The lessee has the right to obtain substantially all of the economic benefits from the use of the land and the right to direct the use of the land.

Example B differs from Example A because the arrangement does not convey the right to control the use of the land for a period of time. The farmer has the right to obtain substantially all of the economic benefits from the use of the land and the right to direct the use of the land.

In many cases, the critical factor would be whether or not the easement holder has exclusive use of a defined space or whether the land owner has significant economic benefits beyond the easement.

The Group's Discussion

Group members noted that this issue is being discussed internationally and provided some preliminary views for consideration.[2]

One Group member leaned towards easements being within the scope of IFRS 16 for the fact patterns presented above (View A). This view is based on the notion that some amount is paid for the use of the land, which seems more aligned with the objective of IFRS 16.

A question was raised regarding whether easements within the extractive industries may also fit within the scope exemption in paragraph 3(a) of IFRS 16. This paragraph states an entity shall apply this standard, except for "leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources."

The presenter noted that in certain jurisdictions, if the material below the ground is owned by the government and the government grants the entity a license to explore, the lease would be excluded from IFRS 16. However, if the material is below the ground but there is a private land owner that owns the rights to access the land above the ground, the rights to access both above and below the ground may fit within the scope exemption of paragraph 3(a) of IFRS 16.

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[2] For example, at its May 10, 2017 meeting, the U.S. Financial Accounting Standard Board discussed whether easements would be within the scope of Topic 842, *Leases*, when currently accounted for as intangible assets. Given it may be reasonable to have more than one view on this question, the Board directed the staff to perform additional outreach with preparers, auditors, and users.

Another Group member commented on horizontal and vertical rights, raising the question of whether IFRS 16 is limited to horizontal rights (i.e., rights to use an identified asset that is within sight as opposed to determining if another right exists below the ground).

One Group member thought it is important to determine whether the lessee has the right to obtain substantially all the economic benefits from the use of the asset throughout the period. Paragraph B20 of IFRS 16 states, in part, that "a capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer the right to obtain substantially all of the economic benefits from use of the asset." For the fact patterns presented above, this Group member leaned more towards View B.

The presenter noted that the preliminary discussions happening in practice highlight the need to understand all the specific rights and obligations in an agreement before being able to determine whether IFRS 16 or IAS 38 applies.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IAS 36: Goodwill Impairment Test

IAS 36 *Impairment of Assets* requires that an entity test goodwill for impairment annually by comparing the carrying amount of the cash-generating unit that includes goodwill with the recoverable amount of the unit. While an annual goodwill impairment test is mandatory, IAS 36 provides some relief for the determination of the recoverable amount.

Paragraph 99 of IAS 36 states:

> "The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met:
>
> (a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;
>
> (b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and
>
> (c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote."

Issue 1: What are some factors an entity would consider in determining whether it can use the most recent detailed calculation of the recoverable amount for the goodwill impairment test?

Judgment is required to assess whether the criteria described in paragraph 99 of IAS 36 have all been met, particularly in determining what constitutes a "substantial margin." In considering what

constitutes a substantial margin between the recoverable amount and carrying amount of the cash-generating unit, an important factor is understanding the amount by which a change in key assumptions could affect the calculation. If a relatively minor change to one of the key assumptions could eliminate the margin, it is less likely that the criterion in paragraph 99(b) of IAS 36 is met. Also, an entity should consider whether a key assumption is expected to change from year to year.

Issue 2: Assuming all the criteria in paragraph 99 of IAS 36 are met, may an entity use the same recoverable amount calculation for multiple annual reporting periods?

View 2A – An entity may use the same recoverable amount calculation for multiple annual reporting periods provided that the criteria in paragraph 99 of IAS 36 continue to be met.

Proponents of this view note that paragraph 99 of IAS 36 does not state the recoverable amount calculation must be from the most recent preceding period. Rather, it is the most recent recoverable amount calculation made in a preceding period.

The likelihood of an event or a change in circumstance occurring increases over time. However, if the margin between the recoverable amount and the carrying value of the cash-generating unit was so substantial such that the likelihood of goodwill impairment remains remote, then the same conclusion could be reached for multiple periods. In this case, the same recoverable amount calculation may be used an indefinite number of times.

View 2B – An entity may not use the same recoverable amount calculation indefinitely but rather only the calculation from the most recent annual reporting period.

Proponents of this view consider that the intention of paragraph 99 of IAS 36 was to provide relief for the current annual reporting period only, not an indefinite relief from the annual goodwill impairment test. Paragraph BC177 in the Basis for Conclusions on IAS 36 states, in part, the following:

> "The Board concluded that in such circumstances, permitting a detailed calculation of the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated to be carried forward from **the preceding period** for use in the current period's impairment test would significantly reduce the costs of applying the impairment test, without compromising its integrity." (emphasis added)

The Group's Discussion

The Group discussed both issues together.

The Group noted that an entity still needs to perform an analysis to assess the likelihood of the current recoverable amount being less than the current carrying amount of the unit when applying paragraph 99 of IAS 36. Entities may find performing the annual goodwill impairment test is less work than conducting a likelihood analysis. One Group member noted that if there are multiple cash-generating units to which goodwill is allocated, the recoverable amount calculation for one unit may exceed its carrying amount by a substantial margin, but not for all units. Since an entity would generally compare the carrying amount of its net assets to its market capitalization based on paragraph 12 of IAS 36, the information to perform the goodwill impairment test is often already available.

Group members' experience suggests that the relief provided by paragraph 99 of IAS 36 is not commonly applied by entities. One Group member acknowledged that the reference to the preceding period is ambiguous and could be interpreted as either being the immediately preceding period or just an earlier period. The facts and circumstances should be assessed because if the cash-generating unit that includes goodwill is clearly not impaired, applying the same recoverable amount calculation for multiple annual reporting periods is less concerning. However, the longer between the most recent recoverable amount calculation and the reporting period in which goodwill is assessed for impairment, the more qualitative analysis needed to justify the use of this relief in paragraph 99 of IAS 36.

This similar relief is also available to an intangible asset with an indefinite useful life based on paragraph 24 of IAS 36. However, one Group member noted that whether this similar relief exists for an intangible asset not yet available for use is not apparent given the wording in paragraph 15 of IAS 36.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 9: Matters for Non-Financial Entities

While the requirements in IFRS 9 *Financial Instruments* are often associated with financial entities, there are some areas that are expected to have an effect on, or could be relevant for, non-financial entities. For example, requirements relating to:

- investments in equity instruments (i.e., in a portfolio of publicly listed companies or in a private company);
- interest-free loans to related parties such as employees; and
- the simplified impairment model for trade receivables.

The Group discussed five issues relating to the above areas to highlight some of the requirements in IFRS 9 that non-financial entities should think about when implementing the standard.

Fact Pattern 1

- Entity A has a portfolio of equity investments that were acquired through various transactions and are not being held for trading. The investments include common shares. Each investment represents less than a 10 per cent interest in the respective entities and does not constitute control or significant influence.
- Under IAS 39 *Financial Instruments: Recognition and Measurement*, Entity A has designated the portfolio of equity instruments at fair value through profit or loss (FVTPL) based on the group of financial assets being managed and its performance being evaluated on a fair value basis.
- During 2017 and 2018, the performance of the investments within the portfolio has varied and some investments have declined in value while others have increased in value.

- When preparing its 2018 annual financial statements, Entity A wants to elect to classify each of the equity instruments that have declined in value during 2017 and 2018 at fair value through other comprehensive income (FVTOCI).
- Entity A's date of initial application of IFRS 9 is January 1, 2018.

Issue 1: What date must Entity A elect to classify its investments in equity instruments and can Entity A designate certain equity investments in the portfolio as FVTOCI while other equity instruments in the same portfolio remain classified as FVTPL?

Based on paragraph 4.1.4 of IFRS 9, investments in equity instruments that would otherwise be measured at FVTPL may present subsequent changes in fair value in other comprehensive income provided the instruments are not held for trading and the entity made this irrevocable election at initial recognition (i.e., designate the equity instrument at FVTOCI).

Although the irrevocable election is permitted on an instrument-by-instrument basis, Entity A must make the irrevocable election based on facts and circumstances at January 1, 2018 and is not permitted to use hindsight to designate some instruments as FVTOCI based on the instruments' performance during either the first quarter of 2018 or the 2018 fiscal year.

The entity needs to document the irrevocable election by the date of initial application, which is January 1, 2018 for the annual period ending December 31, 2018.

The Group's Discussion

Group members agreed with the analysis above, emphasizing that IFRS 9 does not allow the use of hindsight. Therefore, entities would have to make the irrevocable election by the date of initial application.

Fact Pattern 2

- Entity B has an investment in common shares of a private company. The common shares are not being held for trading. The investment represents less than a 10 per cent interest in the private company and does not constitute control or significant influence.
- Under IAS 39, the investment is accounted for as an available-for-sale investment. Measurement of the common shares is at cost because there is no quoted price in an active market and the fair value cannot be reliably measured.

Issue 2: Upon adoption of IFRS 9, will Entity B be able to continue to recognize the investment in common shares of the private company at cost?

As the investment in common shares held by Entity B is an equity instrument, it must be classified as FVTPL unless the entity elects to designate it at FVTOCI. Both classifications require the investment to be measured at fair value.

However, Entity B may continue to recognize the investment in common shares of the private company at cost because of the requirements in paragraph B5.2.3 of IFRS 9, which states:

> "All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value.

> That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range."

Entity B should take into consideration the requirements in paragraph B5.2.4 of IFRS 9 that provides indicators for when cost might not be representative of fair value.

The Group's Discussion

Group members observed that while many entities may seek to use cost as an estimate of fair value, this is not an automatic election that can be made. These entities must first consider whether there are any indicators, such as those in paragraph B5.2.4 of IFRS 9, that cost is not an appropriate estimate for fair value. One Group member observed that more entities are likely to have fair value adjustments related to equity investments than under IAS 39 because of the indicators specified in paragraph B5.2.4 of IFRS 9, particularly indicator (g) regarding subsequent equity transactions at a different price.

One Group member highlighted the guidance in paragraph BC5.18 of the Basis for Conclusions on IFRS 9, which indicates that the IASB concluded it would never be appropriate to use cost as an estimate of fair value for equity investments held by particular entities such as financial institutions and investment funds. Another Group member noted that regardless of whether an entity is a financial institution or investment fund, in many cases the entity will be tracking the performance of its investment, and therefore may have sufficient information to measure the fair value.

One Group member observed that often investments are made to get a foothold in an emerging economy, market or technology. In these cases, because of the difficulty in obtaining information to accurately measure fair value, entities may want to consider whether it is appropriate to use cost as an estimate of fair value. Another Group member noted that entities who use cost as an estimate of fair value will have to consider the requirements to test for impairment.

Fact Pattern 3

- Entity C has provided an interest-free loan to an employee of $100,000. The loan agreement between Entity C and the employee has a maturity date of three years from the initial advance being made. The market interest rate for a similar loan would have been 8 per cent per annum on initial recognition.
- Assume that the employee loan is not linked to future service being provided by the employee nor to shares of Entity C. There is no expectation of selling the loan.

Issue 3: How should a below market rate of interest loan to a related party be classified and measured under IFRS 9?

Based on paragraph 5.1.1 of IFRS 9, all financial instruments are initially recognized at fair value (which is similar to IAS 39). After initial recognition, an entity is required to measure a financial asset in accordance with paragraphs 4.1.1 to 4.1.5 of IFRS 9 at amortized cost, FVTOCI or FVTPL.

The views below focus specifically on the contractual cash flows test and not the business model assessment.

View 3A – Amortized cost.

Based on paragraph 4.1.2 of IFRS 9, a financial asset is measured at amortized cost if it is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows and the contractual terms giving rise to cash flows that are solely payments of principal and interest (SPPI).

Although Entity C earns no interest on the loan, this does not result in the SPPI test being failed because there is no expectation of Entity C selling the employee loan.

For the purpose of the SPPI test, the fair value at initial recognition is considered the principal. The fair value of a loan that carries no interest is measured as the present value of all future cash receipts, discounted using the prevailing market rate of interest for a similar instrument (for example, similar currency, term, type of interest rate) with a similar credit rating. Although the loan pays no interest coupon, Entity C recognizes interest income at the effective interest rate. The imputed interest is considered compensation for the time value of money, credit risk and other risks and costs under a basic lending arrangement.

View 3B – Fair value at either FVTOCI or FVTPL.

Under this view, Entity C earns no interest on the loan because it is not being compensated for the time value of money, credit risk and other risks and costs under a basic lending arrangement. Therefore, the SPPI test would fail and amortized cost classification cannot be applied.

Paragraph 4.1.4 of IFRS 9 states, in part, that "a financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A."

The Group's Discussion

Group members supported amortized cost measurement (View 3A), observing that paragraph 4.1.3 of IFRS 9 states that interest consists of "consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin." IFRS 9 makes no reference to interest being a reasonable amount of compensation. Furthermore, paragraph B4.1.7A of IFRS 9 notes that an instrument that earns negative interest is not disqualified from meeting the SPPI test. Therefore, Group members noted that the same logic can be applied to a loan with zero interest.

One Group member questioned where the difference between the fair value and face value of the loan at initial recognition should be recorded. Another Group member observed that the difference is like a benefit given to the employee and would not meet the definition of an asset. Therefore, the difference should be recognized as an immediate expense. The instrument meets the SPPI test because the discounted loan is accreted to its face value over the term as interest income and the principal is repaid at the maturity date.

Issue 4: Does the classification in Issue 3 change if the lending arrangement includes a prepayment option that may change the timing of the contractual cash flows?

View 4A – No, the classification will not change due to the nature of the prepayment option.

Paragraph B4.1.11 of IFRS 9 provides examples of contractual terms that are still considered to meet the SPPI test. In particular, one of these examples is a contractual term that permits the issuer to prepay a debt instrument or permits the holder to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding.

Based on the fact pattern, the prepayment amount will represent unpaid amounts of principal and interest outstanding. As a result, the SPPI test continues to be met and classification at amortized cost is appropriate.

View 4B – The classification may change depending on the nature or significance of the prepayment option.

The presence of the prepayment option could potentially prevent the financial asset from passing the SPPI test if that asset was acquired for a significant discount. This result is due to Entity C potentially realizing a gain that is not part of the basic lending return.

However, paragraph B4.1.12 of IFRS 9 allows a financial asset to pass the SPPI test if the fair value of the prepayment feature on initial recognition of the financial asset is insignificant, therefore continuing to classify at amortized cost.

View 4C – Yes, the classification will change due to the existence of a prepayment option.

If the prepayment option is viewed to result in Entity C realizing a gain that is not part of the basic lending return, the loan arrangement does not meet the SPPI test and would be classified as FVTPL.

The Group's Discussion

Group members agreed that the classification may change depending on the significance of the prepayment option (View 4B). Specifically, paragraph B4.1.12 of IFRS 9 indicates a debt instrument with a prepayment option can be measured at amortized cost if, among other things, the fair value of the prepayment option is insignificant at initial recognition.

Group members discussed examples of features in lending arrangements they have seen in practice that have resulted in the instrument failing the SPPI test. One Group member observed that embedded derivatives and convertible notes are common examples of such features. Another Group member shared an example in which repayment of principal and interest on a loan to an associate varies based on the cash flows of an asset held by the associate.

One Group member noted that generally, when an entity is in doubt regarding whether a feature in a lending arrangement meets the SPPI test, the assessment should focus on whether the loan meets

the IFRS 9 principle that the instrument is a basic lending arrangement. If not, the entity would need to carefully consider whether the loan passes the SPPI test.

Issue 5: What factors or changes, if any, would a non-financial entity applying the simplified impairment approach be expected to make to their current model to comply with IFRS 9?

For trade receivables that do not contain a significant financing component in accordance with IFRS 15, paragraph 5.5.15 of IFRS 9 requires an entity to always measure the loss allowance at an amount equal to lifetime expected credit losses. If the trade receivables contain a significant financing component, the entity is permitted to apply an accounting policy to measure the loss allowance at an amount equal to the lifetime expected credit losses.

This exception or simplified approach does not require the entity to track changes in credit risk. Instead, the entity recognizes the lifetime expected credit loss.

IFRS 9 does not prescribe how an entity should estimate lifetime expected credit losses when applying the simplified model. The standard permits the use of a provision matrix as a practical expedient for determining lifetime expected credit losses on trade receivables. Currently, in practice many non-financial entities use an impairment model for trade receivables that applies an historical impairment loss percentage based on the number of days a payment is past its due date.

Entities should continue to look at historical customer default rates, adjusted when needed to reflect current conditions. Entities should also incorporate any forward-looking information and segregate or group trade receivables into various customer segments (for example, geographic and product type) with similar loss patterns to calculate the lifetime expected credit losses.

The Group's Discussion

One Group member observed that for some entities, the simplified model may actually be more work than applying the standard IFRS 9 impairment model. This result is because grouping receivables into subpopulations and analyzing each could require significant effort, particularly if an entity operates in multiple jurisdictions or has multiple product lines.

Another Group member observed that it is likely not appropriate for entities who use a model under IAS 39 based on historical default rates to use the exact same model under IFRS 9. While changes may not be extensive, some consideration of forward-looking economic information should be built into the model under IFRS 9.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IFRS 9: Modifications or Exchanges of Financial Liabilities that do not Result in Derecognition

The IFRS Interpretations Committee was asked to clarify the requirements in IFRS 9 *Financial Instruments* relating to the modifications or exchanges of financial liabilities. Specifically, the issue is whether an entity recognizes, in profit or loss, the adjustment to the amortized cost of the financial liability when such modification or exchange does not result in the derecognition of the instrument.

In its March 2017 IFRIC Update, the IFRS Interpretations Committee issued a tentative agenda decision[3] concluding "that an entity applies paragraph B5.4.6 of IFRS 9 to all revisions of estimated payments and receipts, including changes in cash flows arising from modifications or exchanges of financial liabilities that do not result in derecognition of the financial liability. In doing so, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange." This conclusion is consistent with the requirements in paragraph 5.4.3 of IFRS 9 on the accounting for modifications of financial assets, which is new wording introduced in the financial instruments standard.

The Group members discussed the following fact pattern, taking into consideration the IFRS Interpretations Committee's tentative agenda decision.

Fact Pattern

On January 1, 2010, Entity A:

- borrowed $1 million at a fixed rate of 9 per cent per annum for 10 years, interest payable annually in arrears;
- incurred issuance costs of $100,000; and
- accounts for the loan liability using the amortized cost method.

On January 1, 2016, Entity A agreed with the lender to modify the terms of the loan as follows:

- interest rate reduced to 7.5 per cent;
- maturity of the loan extended by two years to December 31, 2021; and
- no fees were involved for renegotiating the loan.

The amortized cost of the loan liability at the date of modification is $947,674 and the present value of the modified loan cash flows discounted using the original effective interest rate is $864,417. The difference between the two amounts is $83,257.

The modification is not considered to be an extinguishment because the discounted present value of the cash flows under the new terms is less than 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. There are no other factors that

[3] Subsequent to the meeting, the IFRS Interpretations Committee decided to refer the matter to the IASB in light of the comments received (June 2017 IFRIC Update).

lead to the conclusion that the modification should be treated as an extinguishment. Entity A's date of initial application of IFRS 9 is January 1, 2018 (i.e., Entity A has not early adopted IFRS 9).

Analysis: Accounting for the difference between the amortized cost of the original loan and the present value of the modified loan at the date of modification under IAS 39 and IFRS 9.

In practice under IAS 39, the amount of $83,257 would be recognized in profit or loss in future periods using the revised effective interest rate. The carrying amount of the loan liability at January 1, 2016 would not have changed (i.e., remains at $947,674).

However, based on the IFRS Interpretations Committee's tentative agenda decision in the March 2017 IFRIC Update, under IFRS 9, the amount of $83,257 would be recognized in profit or loss at the date of modification. The amortized cost of the modified loan liability at January 1, 2016 is $864,417.

Upon transition to IFRS 9, Entity A is required to retrospectively apply paragraph B5.4.6 of IFRS 9 to the modified loan that is outstanding as of the date of initial application. Entity A would need to determine the transitional adjustment required to adjust the financial liability to what the carrying value would have been if the carrying amount was changed to $864,417 and the original effective interest rate of 10.6749 per cent was applied from January 1, 2016 onwards. The transitional adjustment is recorded either to opening retained earnings of the reporting period that contains the date of initial application or the opening date of the comparative period if Entity A elects to restate the prior period figures upon adoption of IFRS 9.

The Group's Discussion

One Group member observed that modifications to liabilities that do not result in derecognition are commonly seen in practice, both for basic lending arrangements and convertible instruments. Group members agreed that the requirement under IFRS 9 to recognize the difference between the amortized cost for the original loan and the present value of the modified loan in profit or loss at the date of modification will result in a change in practice from IAS 39.

Another Group member observed that the IFRS 9 treatment will result in symmetry between the borrower and the lender, because the lender would also recognize the change in amortized cost in profit or loss at the modification date.

A few Group members expressed concern that a structuring opportunity arises under IFRS 9 as a result of the accounting treatment for modifications of liabilities that do not result in derecognition. Specifically, while a change in the interest rate would result in an amount recognized in profit or loss at the date of modification, fees paid by a borrower to a lender would result in adjustment to the carrying amount of the liability. One Group member questioned whether action is required to address this issue given the accounting outcome under IFRS 9 will be different for two transactions for which the substance is the same.

The Canadian member of the IFRS Interpretations Committee provided insight on the Committee's discussion of this issue, noting in particular that this structuring opportunity was specifically acknowledged and discussed by the Committee and the IASB. The IASB decided not to address

this structuring issue on the basis that they wanted to provide a stable platform to stakeholders during the implementation of IFRS 9.

The Group's discussion raises awareness about this item. The AcSB Chair and staff noted that the AcSB will be undertaking additional activities, including highlighting this issue in its IFRS webinar and a few presentations, to raise further awareness amongst Canadian stakeholders of this change. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

IAS 12: Interest and Penalties Related to Income Taxes

The IFRS Interpretations Committee considered whether to add a project on interest and penalties related to income taxes in light of the feedback received to the draft IFRIC Interpretation *Uncertainty over Income Tax Treatments*.[4] The feedback identified that entities apply either IAS 12 *Income Taxes* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to interest and penalties related to income taxes.

The IFRS Interpretations Committee published a tentative agenda decision in its March 2017 IFRIC Update that concluded a project of this nature is not a higher priority than other projects already on the IASB's or Committee's agenda.

The IFRS Interpretations Committee also observed that "if an entity determines that amounts payable or receivable for interest and penalties are income taxes, then the entity applies IAS 12 to those amounts. If an entity does not apply IAS 12 to interest and penalties, then it applies IAS 37 to those amounts."

The Group discussed two fact patterns, taking into consideration the IFRS Interpretations Committee's tentative agenda decision.

Issue: How should an entity account for interest and penalties described in the following two fact patterns?

Fact Pattern 1

- An entity has filed its income tax returns for the year end December 31, 20X7 with the Canadian tax authorities. Included within the tax return is a filing position that the entity is taking with relation to where certain sales contracts are originated, approved and a substantial portion of the work is performed.
- It is the entity's position that the contracts are not taxable in Canada as they relate to income sourced in a foreign jurisdiction. There is a level of uncertainty concerning how the Canadian tax authorities will interpret the entity's filing position. The entity has been challenged in the past, with outcomes ruled both in favour and not in favour under various fact patterns.
- On June 30, 20X8, the taxation authority issues a notice of assessment that the entity's income tax return has been assessed as filed. However, on July 15, 20X8, the taxation authority notifies the entity that they will commence tax audit procedures on the return, including its filing position relating to the contracts in question.

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[4] In June 2017, the IASB issued IFRIC 23 *Uncertainty over Income Tax Treatments*.

- In preparing both its December 31, 20X7 and its December 31, 20X8 financial statements, the entity must consider how it should account for the uncertain tax position, specifically relating to interest and penalties. The taxation authority has not issued a reassessment as the tax audit is ongoing, though there is a significant chance that they will rule against the entity.
- If the taxation authority were to rule against the entity, it would lead to significant penalties based on a percentage of the income taxes not originally paid, plus interest on the late payment of the income taxes owing.

The Group's Discussion

One Group member noted that interest and penalties related to income taxes may not be that material relative to an entity's financial statements. He observed that in practice, the accounting for these amounts does vary between IAS 12 and IAS 37. However, the important point to highlight is that entities should be consistent in how they treat interest and penalties related to income taxes from period to period. If the amount is material, entities should include accompanying disclosures.

Another Group member observed that an entity should first consider whether it had accounted for the uncertain tax position before determining the accounting for interest and penalties that could arise from that position itself. In addition, an entity should also consider the effect the accounting treatment for interest and penalties would have on the rate reconciliation required in IAS 12.

Fact Pattern 2

- An entity has been reassessed on their tax filing by the taxation authority relating to transfer pricing methodologies over a period of three years. The taxation authority has assessed $1 million in taxes owing, plus $200,000 in penalties and $150,000 in interest, for a total of $1,350,000.
- The entity initially opposes the assessment from the taxation authority. However, after weighing the legal costs of disputing the filing, the entity enters into discussions with the taxation authority and agrees to settle the issue.
- The taxation authority states that they will close their file on the issue if the entity pays $800,000 in total, but no specification is given as to how much relates to income tax, penalties and/or interest. The entity accepts this offer and issues payment to the taxation authority.

The Group's Discussion

One Group member thought that the blended tax payment should be presented within current income tax expense in the Statement of Comprehensive Income. However, another Group member noted it was more important to ensure there is adequate disclosure of the blended tax payment than where the amount is presented. That said, if an entity has certain key performance measures (for example, earnings before interest, taxes, depreciation and amortization), the location of where the amount is presented in the Statement of Comprehensive Income could have certain implications.

Another Group member reiterated the importance of consistency in the accounting approach from period to period, but also highlighted how the facts and circumstances could warrant one approach over another. An entity should have some sort of framework (for example, predetermined criteria or

factors) that it would consider in determining when interest and penalties relating to income taxes are accounted for under IAS 12 or IAS 37. Such a framework is important to enable the consistent application of judgment.

A few Group members also shared their experience relating to junior mining entities, indicating how sometimes these interest and penalty amounts could be material if the appropriate filings were not made on time. Often penalties are presented separately for such entities (for example, penalty on flow-through shares).

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

UPDATE ON PREVIOUS ITEMS DISCUSSED BY THE GROUP

IFRS 3 and IAS 39: Transaction Price Allocation

At the November 2016 meeting, the AcSB staff reported to the Group that the AcSB considered the Group's recommendation on this issue and decided to refer it to the IFRS Interpretations Committee. The issue is about how the total cost of purchase should be allocated to individual assets and liabilities when the group of assets acquired is not a business and includes both financial instruments and non-financial items.

In February 2017, the AcSB sent a submission to the IFRS Interpretations Committee.[5]

IAS 21: Source of Exchange Rates

At the November 2016 meeting, the Group discussed this issue and suggested the AcSB consider what additional actions could be taken to raise awareness of the Bank of Canada's announced changes. The AcSB staff published an article in February 2017 to highlight the Group's perspectives on how the changes to the Bank of Canada's published exchange rates could affect IFRS reporters.

OTHER MATTERS

Disclosure Initiative – Principles of Disclosure

In March 2017, the IASB issued a Discussion Paper that suggests principles to make disclosures in financial statements more effective. Canadian stakeholders are encouraged to submit their comments to the IASB by October 2, 2017.

In addition, the AcSB hosted a roundtable in Vancouver and Toronto, and also a virtual roundtable in the month of June. It will be hosting another roundtable in Montreal on July 25, 2017. Register to attend the roundtable in Montreal to share views on the IASB's Discussion Paper.

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[5] Subsequent to the meeting, the IFRS Interpretations Committee discussed the submitted issue (June 2017 IFRIC Update).

Improvements to IFRS 8 Operating Segments (Proposed amendments to IFRS 8 and IAS 34)

In March 2017, the IASB issued an Exposure Draft proposing nine narrow-scope amendments to IFRS 8 including amendments to:

- clarify the criteria that must be met before operating segments can be aggregated; and
- require entities to disclose the title and role of the person or group that performs the function of the chief operating decision maker.

Stakeholders are encouraged to submit their comments to the IASB, and also to the AcSB's corresponding Exposure Draft on this topic, before the comment period deadline of July 31, 2017.

Post-implementation Review – IFRS 13 *Fair Value Measurement*

In May 2017, the IASB issued a Request for Information asking stakeholders for their experience with IFRS 13, a standard that explains how to measure the fair value of assets and liabilities. The Request for Information focuses on four main areas:

- the effectiveness of disclosures about fair value measurements;
- the unit of account and fair value measurement of quoted investments;
- the application of highest and best use when measuring the fair value of non-financial assets; and
- application of judgment.

Stakeholders are encouraged to submit their comments to the IASB before the comment period deadline of September 22, 2017.

IFRS 9: Implementation Matters

The IFRS Interpretations Committee has been discussing a number of issues to support the implementation of IFRS 9 *Financial Instruments*. For example, it previously discussed and issued agenda decisions for the following:

- Commodity loans (March 2017);
- Derecognition of modified financial assets (May 2016);
- Determining hedge effectiveness for net investment hedges (March 2016); and
- Transition issues relating to hedging (January 2016).

The IFRS Interpretations Committee also discussed three other issues that were determined to require standard-setting action:

- Prepayment Features with Negative Compensation (Proposed narrow-scope amendment);
- Measurement of long-term interests in associates and joint ventures (2015-2017 Cycle of Annual Improvements); and
- Fees and costs in 10 per cent test (this issue is being considered for the next cycle of annual improvements).

There are also still three tentative agenda decisions that still need to be finalized by the IFRS Interpretations Committee:

- Modifications and exchanges of financial liabilities that do not result in derecognition (March 2017)[6];
- Centrally cleared derivatives (March 2017)[7]; and
- Financial assets eligible for the election to present changes in fair value in other comprehensive income (May 2017).

Stakeholders are encouraged to stay abreast of the international discussions in this area to assess whether the discussions could affect the implementation of the IFRS 9.

(For opening remarks and updates, including other matters, listen to the audio clip).

PRIVATE SESSION

In November 2016, the AcSB expanded the Group's mandate to include assisting the Board in influencing the development of IFRS Standards (for example, providing advice on potential changes to IFRS Standards). The Group's discussion of these matters will support the AcSB in undertaking various activities to ensure the Canadian perspectives are considered internationally. Since these discussions do not relate to assisting stakeholders in applying issued IFRS Standards, this portion of the Group's meeting is generally conducted in private (consistent with the AcSB's other advisory committees).

IASB Documents for Comments

At the May 2017 meeting, the Group provided input to the IASB staff on the Request for Information, "Post-implementation Review – IFRS 13 *Fair Value Measurement*".

In addition, the Group also discussed the following two documents to assist in the development of the AcSB's response letter:

- IASB Discussion Paper, "Disclosure Initiative – Principles of Disclosure"; and
- IASB Exposure Draft, "Improvements to IFRS 8 *Operating Segments* (Proposed amendments to IFRS 8 and IAS 34)".

[6] Subsequent to the meeting, the IFRS Interpretations Committee decided to refer the matter to the IASB in light of the comments received (June 2017 IFRIC Update).

[7] Subsequent to the meeting, the agenda decision was finalized by the IFRS Interpretations Committee (June 2017 IFRIC Update).