

IFRS[®] Discussion Group

Report on the Public Meeting

June 21, 2018

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 IASB or the IFRS Interpretations Committee can make such a determination.

ITEMS PRESENTED AND DISCUSSED AT THE JUNE 21, 2018 MEETING¹

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¹ The agenda item on IFRS 16: Guidance on "Low Value" Leases was deferred to the October 16, 2018 meeting.

UPDATE ON PREVIOUS ITEMS DISCUSSED BY THE GROUP

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ITEMS PRESENTED AND DISCUSSED AT THE JUNE MEETING

Cryptocurrencies – Mining Activities

At its January 2018 meeting, the Group discussed the accounting for investments in decentralized digital currencies (also referred to as “cryptocurrencies”). At this meeting, the Group discussed various accounting issues related to the mining or validation of a cryptocurrency.

A blockchain is a distributed digital ledger that is used to record transactions over a network of participating computers. The ledger tracks the creation and transfer of cryptocurrencies and other crypto-assets between two parties using their online addresses. Individuals and entities (also referred to as “miners” or “validators”) solve blockchain algorithms to verify the transaction data occurring between the two parties or to increase the overall supply of cryptocurrencies in circulation. Solving blockchain algorithms may involve the use of large amounts of computing power.

Blockchain technology operates using either a “proof-of-work” or a “proof-of-stake” system that determines how the miner or validator is selected to create a new block and how it will be rewarded for maintaining the distributed ledger. Each of these systems is described more fully below:

- **Proof of work** – In this system, miners in the blockchain network compete against each other to solve the cryptographic hash function to validate the transaction and create a new block in the blockchain. The miner who completes this work first is compensated with transaction fees and a predetermined number of newly created cryptocurrency (referred to as “block reward”). Miners are offered the block reward because typically the transaction fees alone are not enough to compensate the miners for the significant hardware and electricity costs involved in solving blockchain algorithms.
- **Proof of stake** – In this system, typically no new cryptocurrencies are created because they have been pre-mined and the total supply is already in circulation. As a result, validators in the blockchain network are selected to validate transactions and create a new block in the blockchain based on the proportion of cryptocurrencies held and staked against the total

amount staked by all those in the network. The validator earns transaction fees for validating the block. If the selected validator authenticates a fraudulent transaction or does not complete the validation, it forfeits a portion of its initial stake. The computing power is a lot less compared to a proof-of-work system because only one validator is involved. There is no need to compete to solve the algorithm, and therefore, validators require a lower return.

For discussion purposes, the Group focused on miners and validators that have a right to transfer the crypto-assets they hold to another party. These crypto-assets are in the form of a virtual currency whose value in fiat currency is driven by market sentiment and the perceived value of the crypto-asset. There are other types of crypto-assets that may bear different rights.

Issue 1: Can the transaction fees earned by cryptocurrency miners and validators be recognized as revenue?

View 1A – The transaction fees earned can be recognized as revenue.

The first step in the revenue recognition model in IFRS 15 *Revenue from Contracts with Customers* is to identify whether there is a contract with a customer. Although there is no explicit contract between the miner or validator and the party initiating the transaction because of the nature of the blockchain network, there is a common understanding that the miner or validator solving the algorithm and creating the new block is entitled to a transaction fee.

Proponents of this view note that the transaction fee is stipulated when the party initiating the transaction requests its validation. The transactions fees are paid in the form of a transfer of cryptocurrency. At the point in time when a new block is created, the performance obligation of the miner or validator is satisfied. Therefore, revenue may be recognized at this time because the miner or validator becomes unconditionally entitled to receive the transaction fee. Paragraph 66 of IFRS 15 indicates that when the consideration received is in a form other than cash, the entity should measure the non-cash consideration at fair value.

View 1B – The transactions fees earned cannot be recognized as revenue.

Proponents of this view think that since there is no explicit contract between the party initiating the transaction and the miner or validator who verifies the transaction, IFRS 15 does not apply. Any inflows of economic resources would not be described as revenue.

The Group's Discussion

Most Group members were of the view that the transaction fees earned can be recognized as revenue (i.e., View 1A) on the basis that the work performed is in the ordinary course of business for cryptocurrency miners and validators. The act of solving the algorithm and creating the new blocks requires a large amount of electricity and computer hardware; therefore, it is typically regarded as more than a casual investment for an entity to operate this business.

One Group member noted that although there is no formal contract between the customer and the miner or validator, the miner or validator has an implied enforceable right to receive compensation when it performs the work for the customer. Another Group member thought that when considering the accounting for the miner's compensation, the transaction fee and the block reward should be bifurcated. This Group member noted that the value proposition for the miner's work lies with

obtaining the block reward because of the value ascribed to cryptocurrencies like Bitcoin. Therefore, the block reward could be viewed separately from the transaction fee in determining the appropriate accounting.

Issue 2: Can the reward of a newly created cryptocurrency (i.e., block reward) resulting from the creation and closing of each new block in the blockchain be recognized as revenue?

In a proof-of-stake system, the cryptocurrencies have typically been pre-mined and the total supply is already in circulation. Therefore, validators do not earn a block reward.

In a proof-of-work system, the accounting considerations will differ based on whether the miners run a core node (referred to as “solo mining”) or contribute computing power to a pool of many miners (or “pool mining”). In general, pooled computing power results in a higher probability of solving the cryptographic hash function.

Solo Mining

View 2.1A – The block reward can be recognized as revenue.

Proponents of this view think that there is an implied contract between all the participants in the blockchain. These participants have a shared understanding that the next miner to create a block will be awarded new cryptocurrencies. This understanding suggests that the customer is the entire community participating in the blockchain, and therefore, the block reward could be recognized as revenue.

View 2.1B – The block reward cannot be recognized as revenue.

Proponents of this view note that IFRS 15 can only be applied if the counterparty to the contract is a customer. There is no direct relationship between a customer and the miner when a block is created and the block reward is generated. As a result, there are no enforceable rights and obligations that may be enforced against any individually identifiable party.

Proponents note that under View 1A of Issue 1, there is a clearly identifiable customer who is paying the transaction fee (i.e., party initiating the transaction) when the block is created. However, with a block reward, there is never a clearly identifiable customer paying the block reward even when the block is created.

Pool Mining

View 2.2A – The block reward can be recognized as revenue.

Miners in a pool will generally contract through standardized terms and conditions with pool operators. These miners pay an administration fee to the pool operator and the fees paid may differ depending on the amount of risk taken on by the pool operator. The payout formula to the miners for each pool may also vary.

Proponents of this view think that because there is a contract between the miner and the pool operator under which the miner provides computing power in return for a share of the rewards of the entire pool, the payout from the pool can be regarded as revenue in accordance with IFRS 15. In a

pool-mining situation, the amount the pool miner expects to receive is variable until such time as a block has been created by the pool.

It may be necessary for an entity to apply the two-step approach in IFRS 15 to determine the amount of revenue to recognize because there is uncertainty about whether the computing power contributed will result in a solved block. An entity should apply the guidance on variable consideration to determine an estimate and then apply the guidance on revenue constraints.

View 2.2B – The block reward cannot be recognized as revenue.

Proponents of this view think that a pooling arrangement may essentially be a form of joint arrangement among the solo miners. It is difficult to conclude that there is a contract to provide services to a pool. Instead, the arrangement is more like the sharing of the block reward among joint venturers. If there is no contract that meets the requirements in paragraph 9 of IFRS 15, revenue cannot be recognized for the block reward.

Issue 3: If the block reward is not recognized as revenue under IFRS 15, how should a miner account for the block reward?

View 3A – Recognize the block reward as other income.

Proponents of this view think that the block reward may be recognized as other income because the newly created cryptocurrency represents an inflow of economic benefits in the form of an increase in assets. This view is predicated on the fact that the newly created cryptocurrency can be reliably measured.

View 3B – Recognize the block reward as an internally generated intangible asset.

Under this view, a miner should consider paragraph 57 of IAS 38 *Intangible Assets* in determining how to account for the block reward. The miner is incurring costs to build, or mine, a cryptocurrency, which is considered an internally generated intangible asset. No revenue or gain is recognized until the resulting cryptocurrency is sold.

However, proponents of this view note that it may be difficult to identify and attribute the costs incurred to create the block reward separately from the costs incurred on all previous unsuccessful attempts to create the next block, given the competitive nature of the mining activity. This consideration could affect whether the block reward is an internally generated intangible asset.

The Group's Discussion

The Group discussed Issues 2 and 3 together.

The Group first discussed solo mining. A Group member noted that until the block reward (i.e., the newly created cryptocurrency) received can be monetized, it is challenging to consider it as revenue. Some entities receiving a block reward may trade the cryptocurrency on exchanges and monetize it into a fiat currency if there is a market for that particular cryptocurrency. Other entities may hold the cryptocurrency with the view that it could eventually be used to pay for goods and services. For example, some vendors currently accept Bitcoin as payment for their products. The value of cryptocurrency comes from the trust of the holders who believe it has value.

Some Group members noted that miners and validators are creating a transaction record in the digital ledger. The transaction record ensures that the same cryptocurrency cannot be transferred to multiple people within the network. Therefore, the miners and validators provide the security that underpins the transfer by solving the algorithm and creating the next block in the blockchain. One could take the view that the miners and validators are providing a service.

One Group member noted that paragraph BC187 in the Basis for Conclusions on IFRS 15 states, in part, that “the amounts to which the entity has rights under the present contract can be paid by any party (ie not only by the customer).” The paragraph uses the healthcare industry as an example of how an entity may determine the transaction price based on amounts paid by the patient, insurance company and/or a governmental organization. Therefore, by analogy, the question becomes whether it is critical to know who is paying the block reward as contemplated under View 2.1B.

Several Group members thought the key question on this issue is whether the block reward is considered a reward for an activity that the entity has performed, or something being created because of the activity. If the latter, the block reward is not revenue or income, but rather, an asset (i.e., which moves the discussion to Issue 3). Alternatively, if the block reward is a reward for an activity performed, then the question becomes whether it is revenue or other income of some sort. The lack of an enforceable right to collect the block reward from another party makes it more challenging to recognize it as revenue.

One Group member thought that this issue was more like a scope issue in terms of whether the inventory or revenue standard applies. One of the challenges with IFRS 15 is that the standard mainly focuses on a contract between two parties, when with cryptocurrency mining, there is a network of participating computers involved. Another Group member pointed out that with a cryptocurrency like Bitcoin, the underlying coding is a pre-programmed set of rules that functions autonomously and is coordinated through a distributed consensus protocol via the blockchain. This concept is referred to as a “decentralized autonomous organization.” The miners and validators are like auditors checking against that coding and running that blockchain protocol to earn a reward. This decentralized concept makes it more challenging to fit into the two-party revenue model underlying IFRS 15.

In terms of pooled mining, most Group members thought similar questions and observations would apply. One Group member thought that having a pool operator might make the identification of a customer in the transaction easier, as the miners are providing the operator the computing power needed to perform the mining activity.

Several Group members observed that activities in the new world economy do not fit nicely into current accounting standards, and that judgment is needed to determine the appropriate accounting.

A representative of the Canadian Securities Administrators noted seeing reporting issuers taking the approach of recognizing revenue in this area, and expressed the view that it is important that there is clarity in the markets on the accounting for transaction fees and block rewards earned.

Overall, the Group recommended monitoring the IASB's discussions on the topic of cryptocurrencies. The IASB will likely be discussing whether any work should be undertaken in this area at its July 2018 meeting. The Group recommended revisiting this topic at its next meeting in October 2018, to discuss any new developments as well as the deferred issue of whether there is an active market as defined in IFRS 13 *Fair Value Measurement* that allows measurement of cryptocurrencies at fair value.

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

IFRS 10 and IFRS 15: Sale of Non-financial Assets Involving Royalty Interest

At its May 30, 2017 meeting, the Group discussed "[IFRS 9, IFRS 15 and IAS 16: Seller's Right to Variable Consideration in an Asset Sale](#)." That discussion mainly focused on the timing of derecognition, and initial recognition and measurement of variable consideration when an entity sells one or more assets that do not constitute a business. The Group supported that the seller's right to variable consideration should be measured with reference to the guidance in the revenue standard on transaction price and recognized as part of the proceeds on sale of the asset on transfer of control.

At this meeting, the Group considered three fact patterns to discuss the accounting, from the seller's perspective, for the sale of non-financial assets in which the seller retains a royalty interest in the non-financial assets sold. Specifically, the Group considered whether these fact patterns would be in the scope of IFRS 15 *Revenue from Contracts with Customers*.

Fact Pattern 1

- Entity A owns a development-stage asset. Once the asset is ready for its intended use, it will be a productive asset. This asset is a non-financial asset and is not a license of intellectual property.
- Entity A enters into an agreement to sell the asset to Entity B in exchange for cash consideration and a future royalty equal to 2 per cent of the proceeds from the sale of the outputs generated by the productive asset once it is ready for its intended use.
- Assume the expenditures to develop the asset meet the recognition criteria under either IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. The disposal of assets accounted for under IFRS 6 *Exploration for and Evaluation of Mineral Resources* is outside the scope of this discussion. Also, assume that the royalty interest is not a financial instrument, and that the royalty is settled in cash and not with the physical outputs generated by the productive asset.
- In this fact pattern, the non-financial asset being sold does not constitute a business and is directly owned by Entity A (i.e., ownership is not through a separate legal entity).

The Group will discuss three issues to highlight the thought process involved in determining the accounting for the sale of the non-financial asset related to Fact Pattern 1.

Issue 1.1 – In cases where control of the asset has been transferred, does IFRS 15 apply to the sale of the non-financial asset that does not constitute a business?

Analysis

Paragraph 69 of IAS 16 states, in part, that “[t]he date of disposal of an item of property, plant and equipment is the date the recipient obtains control of that item in accordance with the requirements for determining when a performance obligation is satisfied in IFRS 15.”

Paragraph 72 of IAS 16 further states the following:

“The amount of consideration to be included in the gain or loss arising from the derecognition of an item of property, plant and equipment is determined in accordance with the requirements for determining the transaction price in paragraphs 47-72 of IFRS 15. 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.”

In certain cases, some think that it is appropriate to deem that Entity A has lost control of 98 per cent of the asset. However, the 2 per cent royalty represents a retained interest in the asset for which control has not been transferred. Evaluating the nature of the transaction and the asset or assets that were sold and retained is an important first step that may involve consideration of the legal form of the arrangement. This determination is outside the scope of the Group’s discussion, and the Group will continue its discussion on the basis that control of 100 per cent of the asset has been transferred to the buyer.

The Group’s Discussion

Group members emphasized the importance of understanding that IAS 16 now refers to the requirements in IFRS 15 to determine when the performance obligation is satisfied for the disposal of an item of property, plant and equipment. The same also applies for the disposal of an intangible asset based on paragraph 114 of IAS 38. Once an entity applies the performance obligation guidance in IFRS 15 and concludes there has been a sale, it also applies the IFRS 15 guidance on determination of transaction price for the variable consideration element.

One Group member noted that this issue likely relates to disposals in fiscal 2018 if the preparer adopted IFRS 15 on January 1, 2018, and applied it retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application (i.e., modified retrospective method). Although the seller may be receiving the royalty interest after the date of initial application of IFRS 15, no adjustment would be made on adoption of IFRS 15 if the sale was completed prior to January 1, 2018 because a view is that the performance obligation related to this sale has been satisfied; it is a completed contract. In other words, the fact that the seller may owe the buyer money under the royalty arrangement does not mean that this is an outstanding performance obligation.

Another Group member questioned whether in this fact pattern, Entity A is actually receiving an asset, for example, a financial instrument that represents a right to a variable cash flow stream to be measured at fair value through profit or loss under IFRS 9 *Financial Instruments*. Another example of the asset could also be a retained undivided interest in the mineral rights representing non-cash consideration to be initially measured at fair value under IFRS 15. Other members noted that the

definition of a financial instrument has not changed, and therefore, it would not be a financial instrument on the basis of the adoption of IFRS 15. However, for the Group's discussion purposes, the fact pattern assumes that the royalty interest is neither recognized as a financial instrument nor recognized as a retained undivided interest in the mineral rights at the date of the sale. These assumptions enable the discussion to focus on highlighting some of the key principles that should be considered under the guidance in IFRS 15 relating to variable consideration.

Issue 1.2 – Assuming IFRS 15 applies on the basis that control of 100 per cent of the asset has been transferred to the buyer, does the 2 per cent royalty represent variable consideration?

Analysis

Paragraphs 50-51 of IFRS 15 indicate that if the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration. Also, the promised consideration can vary if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event.

Entity A is entitled to 2 per cent of the proceeds from the sale of outputs the productive asset generates. This suggests that the amount Entity A will receive is variable in nature and contingent on the outputs generated and sold.

The Group's Discussion

Assuming IFRS 15 applies, Group members supported the analysis that the 2 per cent royalty represents variable consideration because it is contingent on future sales.

One Group member observed that in practice (i.e., before the adoption of IFRS 15), royalty interests are commonly treated as executory contracts. That is, the seller does not recognize an asset for the royalty interest. Rather, recognition occurs when the royalty is received. This Group member pointed out that the definition of a financial instrument has not changed. It would seem counterintuitive that upon the adoption of IFRS 15, such royalty interest becomes a financial instrument. Group members agreed with the observation that a royalty is not a financial instrument prior to the payment being owed.

Issue 1.3 – Assuming that the 2 per cent royalty represents variable consideration, what is the ongoing accounting treatment of the variable consideration?

Analysis

Paragraph 56 of IFRS 15 states that "[a]n entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 53 only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved." This assessment is updated at each period.

The inability or difficulty in measuring the transaction price due to variability does not preclude the recognition of revenue. A certain amount of variable consideration may be estimated in the transaction price at the time of the sale, subject to the constraint requirements of IFRS 15.

At each reporting period, Entity A will need to update its assessment surrounding the uncertainty, and update its assumption accordingly. The requirements in IFRS 15 suggest that Entity A cannot simply wait until the ongoing royalty payments are receivable to recognize some or all of the royalty. Entity A would need to estimate some level of output from the productive asset to support the recognition of variable consideration related to the royalty at an amount that is highly probable of not being reversed in later periods.

It is possible that Entity A may recognize a relatively small amount of the royalty upon the sale of the non-financial asset to Entity B, because the asset is in the early stages of development and there is significant uncertainty about the amount of outputs it will eventually generate. Once there is further certainty resulting from the development of the asset into a productive asset, Entity A would recognize a contract asset under IFRS 15 with a corresponding gain in the Statement of Comprehensive Income. When the actual ongoing royalties are received, Entity A would credit the contract asset with no impact on profit or loss.

The Group's Discussion

Group members supported the analysis above and emphasized the importance of having to update the estimated transaction price (including updating the assessment of whether an estimate of variable consideration is constrained) at the end of each reporting period until the seller's right to receive variable consideration has expired.

A few Group members also noted that in some industries like mining, there is a view that variability in the quantity or quality of minerals extracted, or in market prices, may lead to an accounting outcome in which the variable consideration recognized is small or nil. However, these Group members noted that management typically has information (e.g., the technical reserves report in the mining industry) that provides a basis for a reasonable estimation of the variable consideration. While this information may not be available in the early stages of the development of the asset, some information eventually becomes available. In addition, estimates of future cash flows expected from operating an asset are used for other accounting estimates, such as assessing for impairment of the asset. It would seem logical that this information would also be used for estimating variable consideration, subject to the requirements of IFRS 15 around constraining the amount of variable consideration to be recognized when necessary.

Fact Pattern 2

- The facts and circumstances are similar to those presented in Fact Pattern 1, except that Entity A holds the non-financial asset in a subsidiary that does not constitute a business.
- Entity A sells all of its ownership interests in its subsidiary to Entity B in exchange for cash consideration and a future royalty equal to 2 per cent of the proceeds from the sale of the outputs generated by the productive asset once it is ready for its intended use.

Issue 2: How should Entity A account for the sale of its subsidiary that does not constitute a business?

View 2A – Entity A should account for the sale by looking through its corporate structure and applying IFRS 15.

Proponents of this view note that in U.S. GAAP, entities are required to look through their corporate structure and account for the sale of in-substance non-financial assets under the provisions of Accounting Standards Codification Topic 606 *Revenue from Contracts with Customers*. If this approach is applied, the accounting treatment would be similar to what is described under Fact Pattern 1 because Entity A no longer controls the underlying asset.

Proponents of this view also point out that Fact Pattern 2 bears resemblance to the facts and circumstances underlying the discussions of the IASB when it issued amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures* relating to the sale or contribution of assets between an investor and its associate or joint venture. In those amendments, the IASB distinguishes whether the assets meet the definition of a business to determine the extent of gains or losses to be recognized when an entity sells a controlling interest of a subsidiary to an associate or joint venture. Under this guidance, only transactions related to the asset or group or assets that constitute a business are accounted for under the guidance in IFRS 10.

Since the subsidiary in this fact pattern does not constitute a business, it would seem appropriate to treat the sale of a single-asset subsidiary the same way as the sale of a directly owned asset.

View 2B – Entity A should account for the sale by applying IFRS 10.

Proponents of this view think that Entity A should apply the guidance in paragraph 25 of IFRS 10 because, in effect, Entity A is disposing of an interest in a subsidiary. It is not relevant that the subsidiary is not a business. Entity A should derecognize the non-financial asset in the subsidiary and recognize a gain or loss associated with the loss of control attributable to its former controlling interest.

Since the sale is accounted for under IFRS 10, IFRS 15 does not apply and, therefore, the royalty arrangement does not represent variable consideration under that standard. Depending on the facts and circumstances, the royalty may be considered contingent consideration at the time of sale. However, this specific point is not contemplated under this fact pattern.

Proponents of this view also point out that, different from U.S. GAAP, IFRS Standards do not contain the concept of in-substance non-financial assets. These proponents refer to paragraph BC68 in the Basis for Conclusions of U.S. Financial Accounting Standards Board (FASB) Accounting Standards Update No. 2017-05, which states, in part, the following:

“However, the IASB did not include the concept of an in substance nonfinancial asset in its guidance because the derecognition of a subsidiary, regardless of whether it is an asset or a business, is accounted for in accordance with IFRS 10, *Consolidated Financial Statements*. Because of those differences, the FASB understands that entities applying IFRS do not have

similar questions about the scope of the derecognition guidance and accounting for partial sales of nonfinancial assets.”²

View 2C – The approach in either View 2A or View 2B is acceptable.

Proponents of this view think that both approaches described in View 2A and View 2B are acceptable as long as the approach the entity selects is applied consistently.

The Group’s Discussion

A few Group members supported View 2A on the basis that they view the economic substance of the transaction in Fact Patterns 1 and 2 to be the same. These Group members would not want a different accounting outcome for the same transaction because of the entity’s corporate structure.

Other Group members supported View 2B on the basis that IFRS 10 focuses on whether the subsidiary is a legal entity, not whether it is a business. One Group member noted that the Group previously discussed the accounting for an acquisition of an entity holding a single asset with a non-controlling interest.³ In that discussion, the Group noted that adopting a look-through approach is generally not supported within the principles of IFRS Standards. If it is not possible to look through the corporate structure in an acquisition situation, it would also be consistent not to look through the corporate structure in a disposal situation. Another Group member also thought that the economic substance of the transaction in Fact Patterns 1 and 2 is different when there is a corporate structure in place. Furthermore, it is difficult to analogize to U.S. GAAP when there is a specific requirement in IFRS 10 that calls for a different accounting approach.

The Group also noted that once an entity determines it is within the scope of a specific standard, it is important that all the guidance related to that standard be followed (i.e., rather than mixing it with guidance from other standards). In addition, entities should look carefully at the details of the sale agreement to ensure that the retained interest is not shares of the corporation, as the accounting implications would be different were that the case.

Fact Pattern 3

- The facts and circumstances are similar to those presented in Fact Pattern 1, except that Entity A holds a group of non-financial assets that constitute a business. The group of assets is primarily made up of assets in the scope of IAS 16 and IAS 38. The assets are directly owned by Entity A.
- Entity A sells the group of non-financial assets to Entity B in exchange for cash consideration and a future royalty equal to 2 per cent of the proceeds from the sale of the outputs generated by the business.

² [ASU Update 2017-05](#), February 2017, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.

³ Refer to the Group’s December 2014 discussion on [“IFRS 3, IFRS 6, IFRS 10 and IAS 16: Acquisition of an Entity Holding a Single Asset.”](#)

Issue 3: How should Entity A account for the sale of the group of non-financial assets that constitute a business?

View 3A – Entity A should account for the sale by applying IFRS 10.

Proponents of this view note that in IFRS 10, a subsidiary is defined as “[a]n entity that is controlled by another entity.” No reference is made to legal structure. Since the group of assets meet the definition of a business under IFRS 3 *Business Combinations*, it is reasonable to use IFRS 10 to determine how to account for the gain or loss on disposition without regard to the legal structure.

Proponents of this view also refer to the IASB’s discussion related to the sale or contribution of assets between an investor and its associate or joint venture (as explained under View 2A). It would also seem appropriate to use IFRS 10 by analogy because the group of assets meet the definition of a business in this fact pattern.

View 3B – Entity A should account for the sale by applying IFRS 15.

Proponents of this view think that IFRS 15, rather than IFRS 10, should apply because Entity A is essentially disposing of (i.e., losing control of) a collection of assets that constitute a business. Therefore, the substance of the transaction is the sale of non-financial assets. Such disposals are accounted for under IAS 16 and/or IAS 38, which refer to the requirements in IFRS 15.

View 3C – The approach in either View 3A or View 3B is acceptable.

Proponents of this view think that both approaches described in View 3A and View 3B are acceptable as long as the approach the entity selects is applied consistently.

The Group’s Discussion

Group members supported View 3B on the basis that the corporate structure matters. If an entity tried to analogize to IFRS 10, following the requirements of that standard could result in the recognition of some sort of non-controlling interest component. However, since Entity A owns the assets directly rather than through another legal entity, recognizing any non-controlling interest would produce a counterintuitive accounting outcome.

Overall, the Group’s discussion of the three fact patterns raises awareness about the accounting for the sale of non-financial assets that involve the granting of a royalty interest. 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 and IAS 23: Capitalization of Financing Costs

The third step in the revenue model of IFRS 15 *Revenue from Contracts with Customers* is to determine the transaction price. Paragraph 60 of IFRS 15 requires entities to adjust the promised amount of consideration to reflect the time value of money for contracts with a significant financing component. This requirement applies to payments received both in advance and in arrears. When the payment is recognized in advance, the financing component is recognized as interest expense.

The Group discussed the following fact pattern and consider three issues related to the interest accrued on contract liabilities.

Fact Pattern

- Entity A constructs and sells an apartment unit to a customer. The customer pays the full consideration up front. Entity A concludes that revenue from apartment sales is recognized at a point in time upon delivery of the apartment, which is expected to be three years after the payment.
- The apartment unit is considered a qualifying asset under construction in accordance with paragraph 5 of IAS 23 *Borrowing Costs*.

Issue 1: Do borrowing costs include interest accrued on contract liabilities (i.e., such interest meets the definition of borrowing costs)?

In accordance with IFRS 15, Entity A needs to adjust the transaction price to reflect the financing provided by the customer and accrue interest on the contract liability.

View 1A – No, borrowing costs do not include interest accrued on contract liabilities.

Proponents of this view note that a contract liability is a non-monetary, non-financial liability, as it is settled with goods and services and not with cash or another financial instrument. The nature of the interest accrued on contract liabilities arising from advance payments is similar to interest expense that is recognized from unwinding a discount on decommissioning or restoration provisions. Such interest expense cannot be capitalized under IAS 23, according to paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

Proponents of this view also look to paragraph 6(a) of IAS 23 and think that to meet the definition of a borrowing cost, interest expense should be calculated using the effective interest method as described in IFRS 9 *Financial Instruments*. However, based on paragraph 64 of IFRS 15, the interest accrued on contract liabilities is calculated using a discount rate that reflects the credit characteristics of Entity A, or with reference to a cash alternative.

Another perspective is that the upfront payment from the customer is similar to a progress payment. Based on paragraph 18 of IAS 23, expenditures incurred on a qualifying asset are reduced by any progress payments received.

View 1B – Yes, borrowing costs include interest accrued on contract liabilities.

Proponents of this view think that the issue contemplated in IFRIC 1 is different from the fact pattern. Entity A is, in substance, borrowing cash from its customers instead of borrowing from a financial institution. Economically, the effect is the same as if Entity A borrowed cash from a bank and collected payments from the customer equivalent to the adjusted transaction price as the construction is completed. Under this arrangement, paragraph 8 of IAS 23 would require the capitalization of the interest expense on the borrowings as part of the cost of the qualifying asset.

Proponents of this view also note that paragraph 5 of IAS 23 defines borrowing costs as “interest and other costs that an entity incurs in connection with the borrowing of funds,” and paragraph 6(a) of IAS 23 indicates that borrowing costs “may” include interest expense calculated using the effective interest method as described in IFRS 9. Furthermore, interest accrued on contract liabilities may be calculated with reference to an entity’s borrowing rate based on paragraph 64 of IFRS 15, similar to lease liabilities that are mentioned in paragraph 6(d) of IAS 23.

In addition, given that there is a significant financing component when accounting for the customer payment received under IFRS 15, this upfront consideration is regarded as a borrowing rather than a progress payment.

The Group's Discussion

Most Group members supported the view that borrowing costs include interest accrued on contract liabilities (i.e., View 1B). However, whether the amount is ultimately capitalized to the qualifying asset depends on the facts and circumstances because of the requirements in IAS 23 related to specific borrowings and general borrowings. One Group member noted that the IFRS Interpretations Committee recently discussed what the term “general borrowings” means and it will be important to monitor whether the final agenda decision has any implications for the determination of what is capitalized to the qualifying asset.⁴

A few Group members did not discount the view that borrowing costs exclude interest accrued on contract liabilities (i.e., View 1A). The thinking was that paragraph 65 of IFRS 15 indicates that the effects of financing are recognized as an interest expense. Also, when IFRS 15 was issued, IAS 23 was not amended, thereby suggesting that the financing component in the contract is not eligible for capitalization under IAS 23.

IFRS 15 requires entities to determine if there is a significant financing component in the contract. If there is a significant financing component, it is hard to ignore that there is a financing cost eligible for capitalization. Group members who supported View 1B thought that in the absence of any consideration received upfront, the entity would have to borrow from a financial institution or issue shares to raise capital. At this point, the entity would analyze the requirements in IAS 23 to determine what amounts making up the financing cost should be capitalized.

Issue 2: Assume that interest accrued on contract liabilities meets the definition of borrowing costs (i.e., View 1B) and Entity A had previously elected to apply the borrowing costs exemption in IFRS 1 First-time Adoption of International Financial Reporting Standards. Does the application of the borrowing cost exemption mean that Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively?

Entity A applied the exemption in paragraph D23 of IFRS 1 related to borrowing costs such that IAS 23 is applied prospectively from its date of transition to IFRS Standards (i.e., January 1, 2010). Assume that Entity A adopts IFRS 15 in 2018 and that the contract liability and significant financing component exists at the date of transition to IFRS Standards because the construction period is over 10 years.

IFRS 15 is applied retrospectively using either a fully retrospective method or with the cumulative effect of applying the standard recognized at the date of its initial application as an adjustment to the opening balance of retained earnings.

⁴ Tentative agenda decision issued in June 2018. Refer to [June 2018 IFRIC Update](#), “IAS 23 Borrowing Costs – Expenditures on a Qualifying Asset.”

The question is whether Entity A's application of paragraph D23 of IFRS 1 fixes the starting point of applying IFRS Standards at Entity A's date of transition, or Entity A has to go back to the inception of the contract when applying IFRS 15 retrospectively.

View 2A – No, Entity A needs to go back to the inception of the contract when applying IFRS 15 retrospectively.

Proponents of this view think that the IFRS 1 exemptions are irrelevant for the application of a new accounting policy after the date of transition to IFRS Standards. The transition requirements under IFRS 15 do not set out special accommodations that would fix the starting point to the date of transition to IFRS Standards.

Another point to consider is that entities electing to apply the borrowing cost exemption did so on a voluntary basis at the date of transition. The adoption of IFRS 15 requirements, such as the recognition of a significant financing component on advance payments, should not allow an entity to retrospectively make IFRS 1 elections.

View 2B – Yes, Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively because IFRS 15 implicitly considers the transition requirements under IFRS 1.

Proponents of this view think IFRS 15 implicitly considers the requirements under IFRS 1 and fixes the starting point for the application of a new accounting policy to the date of transition to IFRS Standards. The rationale is that the carrying amounts of the assets and liabilities, and the elections made, when applying IFRS 1 become the basis for subsequent accounting under IFRS Standards.

Entity A would apply the transition requirements under IFRS 15 by taking into consideration its election of the borrowing costs exemption in paragraph D23 of IFRS 1. Entity A should be able to use the same prospective application when it applies the requirements of IAS 23 to interest accrued on its contract liabilities upon adopting IFRS 15.

View 2C – Entity A has an accounting policy choice.

Proponents of this view think that IFRS Standards are not specific on this point, and therefore, an accounting policy choice exists on the adoption of IFRS 15.

The Group's Discussion

Group members supported the view that Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively because IFRS 15 implicitly considers the transition requirements under IFRS 1 (i.e., View 2B).

A question was raised regarding what would happen if an entity transitioned to IFRS Standards but did not make a choice to apply the borrowing cost exemption because, at that time, the entity did not have any borrowing costs to account for under IAS 23. After a brief discussion, a few Group members thought that it may be possible for an entity to indicate that it would have elected to apply the borrowing cost exemption upon transition to apply the accounting under View 2B.

Issue 3: Assume that interest accrued on contract liabilities meets the definition of borrowing costs (i.e., View 1B). What is the effect of the amendments to IAS 23 that were issued in December 2017?

Analysis

The amendments to IAS 23 that were issued in December 2017 as part of the *Annual Improvements to IFRS Standards 2015-2017 Cycle* clarify that an entity treats as general borrowings any borrowings made specifically to obtain a qualifying asset that remain outstanding when the asset is ready for its intended use or sale. The amendments also clarify that funds borrowed specifically to obtain an asset other than a qualifying asset are included as part of the general borrowings pool. The amendments to IAS 23 are effective for annual reporting periods beginning on or after January 1, 2019, and are applied prospectively.

Assume Entity A recognizes revenue for the construction and sale of the apartment over time, and therefore, does not have an asset to which to capitalize borrowing costs. Entity A would need to include the contract liability, being the borrowings, in the general borrowings pool to determine the capitalization rate based on paragraph 14 of IAS 23.

The Group's Discussion

One Group member thought that it was important to first assess whether the borrowings in the fact pattern are considered specific borrowings under IAS 23. In addition, the views on this issue may be affected by the IFRS Interpretations Committee's recent discussion on whether an entity includes expenditures on a qualifying asset incurred before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalization. Specifically, the IFRS Interpretations Committee discussed the fact that paragraph 14 of IAS 23 applies to the extent the entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset. It will be important to monitor whether the final agenda decision has any implications for the determination of what is capitalized to the qualifying asset.⁵

Another Group member offered a different perspective, noting that paragraph BC125 of the Basis for Conclusions on IFRS 15 states, in part, that "[i]n many typical service contracts, the entity's performance creates an asset only momentarily, because that asset is simultaneously received and consumed by the customer." This Group member contemplated whether this paragraph might influence the determination of whether a qualifying asset exists even if the asset was sold immediately after recognition. However, further consideration is required to think through the implications in this context.

Given the current discussions of the IFRS Interpretations Committee and the [tentative agenda decision](#) issued relating to IAS 23, the Group recommended monitoring the outcome of the international deliberations before determining whether further action is needed in this area.

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

⁵ Tentative agenda decision issued in June 2018. Refer to [June 2018 IFRIC Update](#), "IAS 23 *Borrowing Costs – Expenditures on a Qualifying Asset*."

IFRS 13 and IAS 41: Cannabis Accounting – Recognition and Determining Fair Value

IAS 41 *Agriculture* prescribes the accounting treatment and disclosures related to agricultural activities. Below is a summary of the key principles in IAS 41 relevant to the Group's discussion:

- A biological asset or agricultural produce is recognized when: an entity controls the asset as a result of past events; it is probable that future economic benefits associated with the asset will flow to the entity; and the fair value or cost of the asset can be measured reliably.
- A biological asset is measured at its fair value less costs to sell, unless an entity rebuts the presumption that fair value can be measured reliably on initial recognition.
- Agricultural produce harvested from an entity's biological assets is measured at fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying IAS 2 *Inventories* or another applicable standard.
- Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (see IFRS 13 *Fair Value Measurement*).

According to IFRS 13, fair value can be a directly observable market price or estimated using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. For some assets, observable market transactions or market information might be available, while for others this information might not be available. In addition, the fair value measurement of a non-financial asset takes into account the highest and best use of the asset that is physically possible, legally permissible and financially feasible.

Cannabis cultivation, conversion to other products, sale, export and import are subject to varying legal restrictions in various jurisdictions. Such legal restrictions could have an impact on the ability to reasonably estimate the fair value of the product.

The Group discussed the following fact pattern to highlight factors to consider on the recognition of biological assets, and agricultural produce at the point of harvest, in the cannabis industry when legal restrictions on sale exist. In addition, the Group discussed what approach an entity should consider in determining the fair value of the biological assets and agricultural produce.

Fact Pattern

An entity has operations in Jurisdiction A with the intent to sell products to Jurisdiction B. The entity also has an operation in Jurisdiction C. The following provides information about the laws, market prices and/or the entity's activities in each of the jurisdictions.

Jurisdiction A

- The laws permit an entity to cultivate cannabis with a license, but strictly prohibit the sale, purchase, import, or export of raw cannabis. However, the license permits an entity to sell harvested cannabis to Jurisdiction A's governmental department for medicinal purposes. The laws also allow the export of cannabidiol (CBD) oil, provided such oil has insignificant

tetrahydrocannabinol (THC) content level. As such, export and sale to other jurisdictions is permitted.

- The entity holds a license in Jurisdiction A and cultivates two strains of cannabis. A small amount of Strain 1 is grown, and such raw cannabis is sold to Jurisdiction A's governmental department. A substantial amount of Strain 2 is grown and further processed into high-CBD oil (with minimal THC content) for export and sale to Jurisdiction B. The entity can only process its own grown cannabis into CBD oil. The entity is not permitted to purchase raw cannabis for conversion from other growers in Jurisdiction A or from elsewhere. The Strain 2 output is in excess of Jurisdiction A's governmental department's normal volume requirements, and therefore, cannot be sold to Jurisdiction A's governmental department.
- The sales price of raw cannabis to Jurisdiction A's governmental department is low (i.e., \$1 per gram). Strain 1 can be easily valued based on the expected sales price to Jurisdiction A's governmental department and other relevant inputs such as yield, wastage, costs to complete and costs to sell.

Jurisdiction B

- The sales price of raw cannabis within Jurisdiction B is high (i.e., \$7 per gram). However, the entity cannot export or sell the raw cannabis that it cultivates in Jurisdiction A to Jurisdiction B based on the law restrictions in Jurisdiction A.
- The sales price of CBD oil in Jurisdiction B is \$40 per gram of processed oil. The laws of Jurisdiction A allow for the export of CBD oil, which is the processed product from Strain 2.

Jurisdiction C

- The laws only allow for cannabis to be cultivated and sold, under license, for medicinal purposes. It is expected that Jurisdiction C will implement laws that would permit cannabis to be cultivated and sold for recreational purposes. However, the timing of when these new laws would be implemented is uncertain.
- The entity holds a medicinal cannabis license in this jurisdiction and is currently growing significantly more cannabis than it can sell in the medicinal market. The entity intends to have a substantial amount of cannabis in inventory and in the growth stage in order to be the first to sell to the recreational market when the new laws are implemented.
- It is expected that the future recreational cannabis sales price in Jurisdiction C will be higher than the current medicinal cannabis sales price (i.e., \$10 per gram recreational versus \$8 per gram medicinal).

Issue 1: Do the Strain 2 cannabis in Jurisdiction A and the cannabis in excess of what can be sold for medicinal purposes in Jurisdiction C (i.e., excess cannabis) meet the recognition criteria?

The following views focus on whether it is probable that future economic benefits associated with growing cannabis will flow to the entity given the legal environment described in the fact pattern. The entity controls the Strain 2 cannabis and excess cannabis that it cultivates and the entity is able to measure fair value reliably, with Issue 2 discussing how fair value should be determined.

View 1A – Recognition criteria are met.

While Strain 2 cannabis is not saleable in its raw form in Jurisdiction A, it is a critical input into CBD oil. As a result, proponents of this view think that the entity has an expectation of obtaining future economic benefits if there is a reasonable expectation that the raw cannabis will be converted into CBD oil. The benefit to the entity is similar to a raw material input used in a conversion process to create a saleable product.

For the excess cannabis in Jurisdiction C, proponents of this view think that the entity should assess the likelihood and timing of the implementation of the new laws that would permit the sale of recreational cannabis. If it is probable that the new laws will be implemented that would result in the flow of future economic benefits to the entity, the recognition criteria are met. The fact that the effective date of the implementation of such laws is uncertain does not preclude the recognition criteria being met.

View 1B – Recognition criteria are not met.

Proponents of this view think that the recognition criteria are not met because the entity is not able to realize the future economic benefits from Strain 2 in its raw form. The Strain 2 output is in excess of Jurisdiction A's governmental department's normal volume requirement and the laws of Jurisdiction A do not allow for export of raw cannabis.

For the excess cannabis in Jurisdiction C, proponents of this view think that it is not probable that future economic benefits will flow to the entity when the excess cannabis cannot legally be sold until the new laws are implemented.

The Group's Discussion

Group members agreed that the recognition criteria are met for the Strain 2 cannabis because it is clear that benefits would flow to the entity from the production and sale of CBD oil (i.e., View 1A). Group members also agreed that the excess cannabis in Jurisdiction C meets the recognition criteria (i.e., View 1A), and that issues such as risks surrounding the timing of the prospective legalization of recreational cannabis should be factored into the measurement of the asset.

Issue 2: Assuming that the recognition criteria are met and that fair value can be reliably measured, what approach should an entity consider in determining the fair value of its Strain 2 cannabis in Jurisdiction A and excess cannabis in Jurisdiction C?

View 2A.1 – The entity should consider a market approach that is based on the market price for which the harvested cannabis could be sold in its current state and location.

For Strain 2 cannabis, an observable price for a similar product (i.e., Strain 1 raw cannabis) exists in Jurisdiction A. This is the most reliable measure of fair value of raw cannabis in its current state and location. Accordingly, the market price of Strain 1 sold to Jurisdiction A's governmental department should be used to estimate the fair value at harvest of the Strain 2 cannabis in its raw form (i.e., \$1 per gram). The entity does not have access to Jurisdiction B, and therefore, cannot use the related market prices due to legal restrictions.

In Jurisdiction C, only medicinal cannabis can currently be sold at \$8 per gram. This observable market price is considered the best measure of fair value of the cannabis in its current state and location.

View 2A.2 – For Strain 2 cannabis only, the entity should consider a market approach that is based on the observable market price in Jurisdiction B.

Proponents of this view think that Jurisdiction A's raw cannabis price is irrelevant because the entity cannot sell the Strain 2 cannabis to Jurisdiction A's governmental department given the output is in excess of the governmental department's normal volume requirements.

The highest and best use for Strain 2 cannabis is to process and convert it into CBD oil for sale in Jurisdiction B. Therefore, the fair value measurement of the Strain 2 cannabis should take into account the observable price prevalent in the ultimate market of the end product.

The raw cannabis price in Jurisdiction B (i.e., \$7 per gram) better represents the fair value of the Strain 2 cannabis prior to the conversion process.

View 2B – The entity should consider an income approach that is based on the expected sales price of the product to be sold.

Proponents of this view think that since the Strain 2 cannabis in its raw form cannot be sold in Jurisdiction A or Jurisdiction B, the raw cannabis prices in those jurisdictions are irrelevant. The fair value of the Strain 2 cannabis at the point of harvest should be based on the \$40 per gram price of the CBD oil that will be sold, less all costs to convert and sell. In addition, a reasonable profit margin to be earned on the conversion phase of the product cycle should be deducted to ensure that the fair value at point of harvest represents only the component relating to Strain 2 cannabis in its raw form.

Proponents of this view also think that since the excess cannabis in Jurisdiction C will not be sold in the medicinal market, the medicinal market price is irrelevant. The entity expects to sell the excess cannabis in the future recreational market. Therefore, the recreational sales price of \$10 per gram should be used as an input to the fair value model. Additionally, the estimates relating to spoilage, wastage, yield and selling costs should incorporate an assessment of the timeline by which the recreational cannabis will be saleable and the shelf-life of the harvested produce.

The Group's Discussion

Group members expressed diverse views with regards to Issue 2. Group members noted that the starting point of determining the fair value less costs to sell of an immature plant at the reporting period should be its fair value at the point of harvest. However, several concerns were raised about how the requirements of IFRS 13 might be applied to arrive at that fair value.

Some Group members supported View 2B that the fair value of the excess cannabis in Jurisdiction C could be determined by using the expected selling price at the point of harvest as a starting point. The expected selling price of \$10 per gram in the recreational market would have to be adjusted for any restrictions on its sale. These Group members noted that if adjustments are made to a Level 1 or Level 2 input, such as an observable selling price, the resulting fair value measurement might be categorized within a lower level of the fair value hierarchy.

However, other Group members thought that it would not be appropriate to use a different selling price as a starting point for the excess cannabis in Jurisdiction C than would be used for the medicinal cannabis, which is sold for \$8 per gram. These Group members observed that, if the products are identical, then it may be difficult to justify the use of different selling prices in arriving at their fair value.

One Group member observed that volume constraints on the sale of a particular strain of cannabis at one price might be considered an indication that a different selling price is a more appropriate starting point for determining the fair value of the excess product.

Overall, the Group's discussion highlighted that entities must exercise significant judgment in fair valuing their biological assets. The Group noted that the factors to consider in determining fair value less costs to sell will be very dependent on the specific facts and circumstances of an entity. As a result, it is important that there are sufficient disclosures about the entity's valuation technique to provide users with the information they need. The Group recommended no further action to the AcSB on the two issues discussed.

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

IAS 41: Cannabis Accounting – Costs Incurred Related to Biological Transformation

Paragraph 12 of IAS 41 *Agriculture* states that “[a] biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell [FVLCS], except for the case described in paragraph 30 where the fair value cannot be measured reliably.”

Once the cannabis plant has been harvested, the costs incurred thereafter are within the scope of IAS 2 *Inventories*. However, questions arise with regards to how to account for the costs incurred related to the biological transformation of the biological asset between the point of initial recognition and the point of harvest (also referred to as “subsequent expenditures”).

Paragraph B62 of the Basis for Conclusions on IAS 41 states, in part, that “[t]he Board decided not to explicitly prescribe the accounting for subsequent expenditures related to biological assets in the Standard, because it believes to do so is unnecessary with a fair value measurement approach.”

The Group discussed the following fact pattern to highlight some of the considerations on the accounting for subsequent expenditures related to the development of biological assets.

Fact Pattern

- An entity has cannabis plants that are measured at FVLCS of \$200 at December 31, 2017, which is near the beginning of their growth cycle.
- During the first quarter of 2018, \$300 of expenditures are incurred to grow the cannabis plants, and the FVLCS of the cannabis plants at March 31, 2018 is \$600.

Issue 1: Should the subsequent expenditures relating to the development of biological assets that are measured at FVLCS be expensed or capitalized?

The accounting treatment of subsequent expenditures affects disclosures and expenditure classification in the Statement of Comprehensive Income.

The figure below illustrates the fact pattern above and the effect under the two views (i.e., Views 1A and 1B) discussed below.

	View 1A		View 1B	
	Expense Subsequent Expenditures	Profit or Loss Impact	Capitalize Subsequent Expenditures	Profit or Loss Impact
	Biological Asset Continuity Debit / (Credit)	Debit / (Credit)	Biological Asset Continuity Debit / (Credit)	Debit / (Credit)
FVLCS, December 31, 2017	\$200		\$200	
Capitalized to biological assets			\$300	
Expensed		\$300		
Change in FVLCS on growing cannabis	\$400	(\$400)	\$100	(\$100)
FVLCS, March 31, 2018	\$600		\$600	
Net Profit or Loss impact		(\$100)		(\$100)

View 1A – Expense subsequent expenditures.

Proponents of this view think that the requirements of IAS 41 could mean that the remeasurement of FVLCS of cannabis plants up to the point of harvest is meant to capture the changes in value throughout the biological transformation of the cannabis plants in profit or loss.

The true change in fair value should not be shown net of expenditures made during the period. By expensing subsequent expenditures, a financial statement user is able to see the change in FVLCS separate from the subsequent expenditures incurred to grow the biological asset (i.e., gross presentation).

View 1B – Capitalize subsequent expenditures.

Proponents of this view think that it would make sense that the amount shown as a change in FVLCS should be net of subsequent expenditures incurred as those costs contributed to the growth of the plants, and therefore, the increase in FVLCS. This approach would result in the change in fair value gain or loss on the growing cannabis being attributed purely to the natural growth of the plants.

View 1C – There is an accounting policy choice.

Proponents of this view refer to paragraph BC62 of the Basis for Conclusions on IAS 41 and think that an entity could develop an accounting policy choice since IAS 41 intentionally does not prescribe the accounting for subsequent expenditures. Such a policy could be developed based on principles in other standards by analogy and should be clearly disclosed.

The Group's Discussion

Group members supported View 1C because IAS 41 intentionally does not prescribe the accounting for subsequent expenditures to grow biological assets. A representative of the Canadian Securities Administrators noted that since IAS 41 does not prescribe how an entity should account for subsequent expenditure in relation to biological assets, an entity is required to develop an accounting policy with reference to guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 requires, among other things, that management use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

One Group member observed that the Basis for Conclusions on IAS 23 *Borrowing Costs* refers to paragraphs B61 and B62 of the Basis for Conclusions on IAS 41 in explaining why the IASB decided not to require the capitalization of borrowing costs relating to assets that are measured at fair value, but did not prohibit presenting items in profit and loss as if borrowing costs had been capitalized. This Group member supports an accounting policy choice to capitalize or expense borrowing costs on investment properties measured at fair value in accordance with IAS 40 *Investment Property* and, as a result, thinks that an accounting policy choice is also supportable for subsequent expenditures related to producing biological assets.

Another Group member noted that there is diversity in accounting for subsequent expenditures in jurisdictions outside Canada, and that this is anecdotal evidence of an accounting policy choice.

Although most Group members supported View 1C, some were also of the view that capitalizing subsequent expenditures would result in a gross profit that was more understandable to users of financial statements. These Group members thought that increases in the fair value of biological assets should be presented net of the expenditures to produce them.

Issue 2: If subsequent expenditures should be capitalized, how would an entity determine what costs to capitalize?

View 2A – Analogize to IAS 2.

Proponents of this view note that the cannabis plants will yield only a single harvest and will be replaced by agricultural produce in scope of IAS 2 on the day they are harvested, and measured in accordance with IAS 2 from that point onward. As a result, IAS 2 provides the most relevant cost guidance to determine which expenditures should or should not be capitalized during the development of the biological assets.

Also, analogizing to IAS 2 may be more appropriate than analogizing to IAS 16 *Property, Plant and Equipment* in this fact pattern as the plants are not bearer plants. Paragraphs 10 to 18 of IAS 2 may help an entity develop an accounting policy for determining what costs to capitalize during the development of biological assets.

View 2B – Analogize to IAS 16.

Proponents of this view think that, prior to harvest, the cannabis plants do not represent inventory. Instead a biological asset is being developed in order to produce inventory. As such, even though the biological asset will produce only one harvest, proponents of this view believe it is appropriate to analogize to IAS 16.

Immature bearer plants are accounted for under IAS 16 similar to construction in progress based on paragraph 22A of IAS 16. Paragraph 22 of IAS 16 further states, in part, that “[t]he cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see IAS 2).”

While judgment is required as to what costs would be capitalized, proponents of this view think paragraph 22 of IAS 16 suggests that an IAS 16 approach is likely to yield a capitalized cost amount that is generally the same as an IAS 2 approach.

Proponents of this view note that for certain biological assets, distinguishing the cost of maintaining a mature biological asset from costs that contribute to the asset's biological transformation or improve its anticipated yields is a significant judgment. However, this is less likely to be a significant judgment for cannabis plants as such plants are harvested once they are mature.

Paragraphs 16 to 22A of IAS 16 may help an entity develop an accounting policy for determining what costs to capitalize during the development of biological assets.

View 2C – There should be an accounting policy choice on the standard to which to analogize.

IAS 41 does not prescribe how an entity should account for subsequent expenditures. As a result, an entity could select an accounting policy for capitalizing subsequent expenditures that is broadly consistent with the principles in other standards (i.e., either IAS 16 or IAS 2) as long as the policy is disclosed and is applied consistently.

The Group's Discussion

Group members discussed whether there would be a different accounting outcome based on the standard to which an entity analogizes the determination of cost and concluded that the results could be different, particularly where judgment is required. One Group member noted that IAS 16 is more stringent with regards to the capitalization of non-production overhead costs.

Some Group members supported View 2A, noting that there is a natural relationship between IAS 41 and IAS 2 because agricultural produce beyond the point of harvest is within the scope of IAS 2.

One Group member thought that the development of the biological asset is not inventory, and therefore, analogizing to IAS 16 may be more appropriate. Another Group member observed that entities should consider the effect of how they account for subsequent expenditures on other financial statements, such as the Statement of Cash Flows, and whether analogizing to IAS 16 would be appropriate if these expenditures were reflected as investing activities.

Other Group members supported the view that there should be an accounting policy choice because IAS 41 is silent on the accounting treatment for subsequent expenditures. These Group members observed that entities need to think about what approach would produce the most relevant results for financial statement users.

After considering the diversity in views expressed, the potential effect on financial statements, and the rapid growth of the industry, the Group recommended that Issues 1 and 2 be discussed with the AcSB to determine whether they 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](#)).

IAS 2 and IAS 41: Cannabis Accounting – Presentation

Paragraph 12 of IAS 41 *Agriculture* states that “[a] biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case described in paragraph 30 where the fair value cannot be measured reliably.”

Paragraph 40 of IAS 41 requires the disclosure of “the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and from the change in fair value less costs to sell [FVLCS] of biological assets.” However, IAS 41 does not prescribe how these amounts should be presented in the Statement of Comprehensive Income.

The Group discussed the following fact pattern to highlight some of the considerations on how to present changes in FVLCS of the cannabis plants in the Statement of Comprehensive Income.

Fact Pattern

- During the year, an entity incurred subsequent expenditures of \$500 on growing cannabis plants. These biological assets were measured at a FVLCS of \$600.
- Of these biological assets, assets measuring \$360 in FVLCS were harvested, reducing the remaining biological assets to \$240 in FVLCS at the year-end reporting date.
- Assume no expenditures were incurred post-harvest to further process and convert the agricultural produce to finished goods inventory. During the same year, the entity sold inventory with a carrying value of \$60 for \$80.

Figure 1 below illustrates the fact pattern, assuming the entity established an accounting policy to either expense subsequent expenditures as incurred or capitalize the subsequent expenditures. Subsequent expenditures are costs incurred related to the biological transformation of the biological asset between the point of initial recognition and the point of harvest. Note: an entity’s accounting policy in accounting for subsequent expenditures may affect the presentation of changes in FVLCS of biological assets.

Figure 1

	Expense Subsequent Expenditures			Capitalize Subsequent Expenditures		
	Biological Asset Continuity Debit / (Credit)	Inventory Continuity Debit / (Credit)	Profit or Loss Impact Debit / (Credit)	Biological Asset Continuity Debit / (Credit)	Inventory Continuity Debit / (Credit)	Profit or Loss Impact Debit / (Credit)
FVLCS, beginning of year	\$0			\$0		
Expenditures on growing cannabis			\$500	\$500		
Change in FVLCS on growing cannabis	\$600		(\$600)	\$100		(\$100)
Point of harvest	(\$360)	\$360		(\$360)	\$360	
Sale of cannabis – revenue			(\$80)			(\$80)
Sale of cannabis – cost		(\$60)	\$60		(\$60)	\$60
FVLCS, end of year	\$240	\$300		\$240	\$300	
Net Profit or Loss impact			(\$120)			(\$120)

Issue: How should the changes in the FVLCS of cannabis plants (i.e., biological assets) be presented in the Statement of Comprehensive Income?

Various approaches to presentation (see Figure 2)

Paragraph 85 of IAS 1 *Presentation of Financial Statements*, in part, requires an entity to present additional line items in the Statement of Comprehensive Income when such presentation is relevant to an understanding of the entity's financial performance. Paragraph 97 of IAS 1 requires that when items of income or expense are material, an entity shall disclose their nature and amount separately. Consequently, unrealized gains or losses resulting from the fair value changes of biological assets should be presented as a separate line item on the face of the Statement of Comprehensive Income. However, the question arises as to the most appropriate location to disclose these amounts. Illustrative Example 1 in IAS 41 illustrates a presentation approach based on the nature rather than function of expenses.

Figure 2 below, comprising Figures 2A to 2E, presents various presentation approaches based on the fact pattern. Each approach illustrates a presentation approach assuming subsequent expenditures are either expensed or capitalized.

- Figure 2A presents separately both the change in FVLCS of biological assets and the realized portion thereof on agricultural produce transferred to inventory and then sold. Figure 2A presents two gross profit subtotals – before and after the net unrealized changes in FVLCS of biological assets.
- Figure 2B does not separately present the realized portion of the FVLCS of agricultural produce in inventory that was sold, where an entity capitalizes subsequent expenditures. The gross profit subtotal presents a measure of gross profit that is consistent with the second gross profit measure in Figure 2A.
- Figure 2C presents the realized portion of the FVLCS of agricultural produce in inventory that was sold, together with the change in FVLCS of biological assets on a single line. This presentation approach shows the net unrealized change in FVLCS related to biological assets.

- Figure 2D is similar to Figure 2B, except that it draws a gross profit subtotal before changes in FVLCS of biological assets.
- Figure 2E shows the items within the Statement of Comprehensive Income based only on the nature of expenditures (rather than the function of expenditures). While this approach does not present either a cost of goods sold line item or gross profit subtotal, each line item faithfully represents the nature of what it purports to represent.

Figure 2

Figure 2A			Figure 2B			Figure 2C		
Statement of Comprehensive Income (debit) / credit	Subsequent Expenditure		Statement of Comprehensive Income (debit) / credit	Subsequent Expenditure		Statement of Comprehensive Income (debit) / credit	Subsequent Expenditure	
	Exp	Cap		Exp	Cap		Exp	Cap
Revenue	80	80	Revenue	80	80	Revenue	80	80
Production expenses	(500)		Production expenses	(500)		Production expenses	(500)	
Cost of sales other than FVLCS adjustments		(50)	Realized portion of change in FVLCS on inventory sold	(60)		Cost of sales other than FVLCS adjustments		(50)
Gross profit before FVLCS adjustments	(420)	30	Cost of sales including realized portion of change in FVLCS on inventory sold		(60)	Changes in FVLCS of biological assets less realized portion on inventory sold	540	90
Change in FVLCS of biological assets	600	100	Change in FVLCS of biological assets	600	100	Gross profit including unrealized FVLCS adjustments	120	120
Realized portion of change in FVLCS of biological assets on inventory sold	(60)	(10)	Gross profit including unrealized FVLCS adjustments	120	120	Net income/comprehensive income	120	120
Gross profit including unrealized FVLCS adjustments	120	120	Net income/comprehensive income	120	120			
Net income/comprehensive income	120	120						

Figure 2D			Figure 2E		
Statement of Comprehensive Income (debit) / credit	Subsequent Expenditure		Statement of Comprehensive Income (debit) / credit	Subsequent Expenditure	
	Exp	Cap		Exp	Cap
Revenue	80	80	Revenue	80	80
Production expenses	(500)		Change in FVLCS of biological assets	600	100
Realized portion of change in FVLCS on inventory sold	(60)		Production expenses	(500)	(500)
Cost of sales including realized portion of change in FVLCS on inventory sold		(60)	Change in biological assets - Costs capitalized		500
Gross profit before change in FVLCS of biological assets	(480)	20	- Transfers to inventory	(360)	(360)
Change in FVLCS of biological assets	600	100	Change in inventory	300	300
Net income/comprehensive income	120	120	Net income/comprehensive income	120	120

View A – All approaches in Figure 2 are acceptable.

Proponents of this view note that neither IAS 1 nor IAS 41 prescribe any specific presentation approaches, and that neither the detailed composition of cost of goods sold nor gross profit are explicitly defined in IFRS Standards. As a result, as long as entities are transparent and clear in terms of both their policy for either expensing or capitalizing subsequent expenditures, and where those subsequent expenditures and the changes in FVLCS of biological assets have been presented in the Statement of Comprehensive Income, any of the presentation alternatives in Figure 2 are acceptable.

View B – An entity must consider its specific circumstances and determine the most appropriate and relevant presentation.

Proponents of this view note that IAS 1 requires that management select the method for presentation of expenses that is reliable and more relevant because both the function of expense method and the nature of expense method may have merit for different types of entities.

In addition, whether an entity expenses or capitalizes subsequent expenditures may have a role in determining the appropriate presentation of gross profit subtotals. Proponents of this view think that if an entity has chosen to expense subsequent expenditures as incurred, then presenting a gross profit subtotal that includes expenditures related to items not yet sold would not be appropriate.

View C – This view is consistent with View B except that it is not appropriate to present a gross profit subtotal that includes unrealized changes in FVLCS of biological assets.

Proponents of this view see gross profit solely as a measure of realized margin over cost of goods sold. As such, proponents of this view agree with View B except that they think it is not appropriate to present gross profit including unrealized changes in FVLCS of biological assets.

The Group's Discussion

Group members had differing views on the appropriate presentation of unrealized gains and losses on changes in the FVLCS of biological assets, and the related effect of the entity's policy to capitalize or expense subsequent expenditures incurred on biological assets.

Several Group members supported View B because they agreed that it is important to consider what presentation approach provides financial statement users with the most relevant and reliable information. If an entity expenses subsequent expenditures as incurred, then presenting a gross profit subtotal that includes expenditures related to items not yet sold, as shown in Figures 2A and 2D, would be misleading.

A representative of the Canadian Securities Administrators (CSA) noted that this is an area in which there has been a lack of clarity in the markets. This CSA representative observed that View B and the presentation approach in Figure 2A are becoming more common in practice, and provides users of financial statements a greater disaggregation of items included in gross profit. This CSA representative also noted that this presentation approach provides more relevant and reliable information to investors when subsequent expenditures related to biological assets are capitalized, rather than expensed.

A few Group members supporting View B preferred the presentation approach in Figure 2B because they think that this approach results in a presentation of cost of goods sold and gross profit that is meaningful to users of financial statements. One Group member thought Figure 2D might also be reasonable if the thinking was that the change in fair value less cost to sell should be part of gross profit. However, this Group member held the view that a meaningful gross profit measure should be specific to the goods sold rather than including fair value changes for goods that are still in inventory.

Some Group members supported View C because they think it is not appropriate to present a measure representing gross profit including unrealized changes in FVLCS of biological assets, as

shown in Figures 2A to 2C. A Group member observed that including unrealized gains and losses on changes in FVLCS would obfuscate underlying performance because it is so volatile.

Group members agreed that IAS 1 and IAS 41 do not prescribe any specific presentation for changes in the FVLCS of biological assets. Entities must consider the users of their financial statements and provide information that is sufficiently disaggregated and transparent to determine what is included and not included in the financial statement line items presented.

The Group's discussion highlighted the diversity in approaches to the presentation of gross profit when applying IAS 41, and the importance of transparency to financial statements users given the rapid growth of the industry. 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 9: Modifications or Exchanges of Fixed-rate and Floating-rate Financial Instruments

At its January 2018 meeting, the Group discussed the IASB's clarification on the accounting for modifications or exchanges of financial liabilities. This clarification was included in the Basis for Conclusions on IFRS 9 *Financial Instruments* as a result of the amendments to IFRS 9 for "Prepayment Features with Negative Compensation," which were issued in October 2017. The clarification indicated that an entity applies paragraph B5.4.6 of IFRS 9 to such transactions and a gain or loss should be recognized in profit or loss at the date of the modification or exchange.

One of the issues discussed by the Group was whether the clarification would apply to a debt instrument with a lack of prepayment penalty. At that time, the Group noted that the issue was being discussed globally, with views held on both sides.

The Group continued its discussion on this topic using the following fact pattern.

Fact Pattern

- Entity A has debt with an interest rate of LIBOR + 200 with a prepayment option at par without penalty payable by Entity A or receivable by the lender.
- Entity A subsequently renegotiates the terms of the debt with the lender such that the debt now has an interest rate of LIBOR + 175, reflecting the current market rate. No other contractual terms were modified. Entity A incurred transaction costs as part of the renegotiation.
- At the time of the renegotiation, Entity A has the practical ability to refinance the debt with other lenders, without penalty.

Issue: How should Entity A account for the renegotiation of the floating-rate debt instrument?

View A – Entity A should apply the modification guidance in IFRS 9.

Under this view, in accordance with paragraph 3.3.2 of IFRS 9, Entity A would assess whether the renegotiation to the current market rate resulted in a substantial modification of the terms of the debt. The same guidance would apply to the renegotiation of a fixed-rate financial instrument.

If the modification is considered substantial, paragraph B3.3.6 of IFRS 9 would apply. The modification is accounted for as an extinguishment of the original financial liability, including any unamortized transaction costs, and a new financial liability would be recognized. In addition, the transaction costs incurred as part of the renegotiation are recognized as part of the gain or loss on extinguishment of the original debt instrument.

If the modification is not considered substantial, paragraph B5.4.6 of IFRS 9 would apply. The entity recalculates the amortized cost of the financial liability using the financial instrument's original effective interest rate to reflect the actual and revised estimated contractual cash flows. The adjustment is recognized in profit or loss as income or expense. Transaction costs incurred as part of the renegotiation are recognized as an adjustment to the carrying amount of the liability and are amortized over the remaining term of the modified liability.

View B – Entity A should apply the extinguishment guidance in IFRS 9.

Under this view, a financial instrument with the option to prepay without penalty that is renegotiated to a current market rate with the same lender has the same economic substance as an instrument for which the prepayment option is exercised, with a third-party lender issuing a new instrument at market rates.

Entity A accounts for the renegotiation as an extinguishment of the original debt, including any unamortized transaction costs, and the recognition of the new debt. In addition, the transaction costs incurred as part of the renegotiation are recognized as part of the gain or loss on extinguishment of the original debt instrument.

The Group's Discussion

In terms of how Entity A should account for the renegotiation of the floating-rate debt instrument, the presenter noted that in addition to the two views identified, another view is possible. Since the entity can prepay the debt without penalty, in substance it is like a variable-rate debt that resets to current market rates. In that case, paragraph B5.4.5 of IFRS 9 applies and there is no significant effect on the carrying amount of the liability.

One Group member noted that there has been a shift in global discussions on this issue, resulting in the acceptance of both View A and View B (i.e., apply the modification or extinguishment guidance in IFRS 9). Another Group member also noted seeing some acceptance of the view that paragraph B5.4.5 of IFRS 9 applies because if the entity can prepay the original debt and approach another lender to obtain a new debt at a lower rate, it is likely the original lender would give the lower rate to the entity. Therefore, in substance, a financial instrument with an insignificant prepayment penalty is like a variable-rate debt.

For this particular fact pattern, several Group members thought View B (i.e., apply the extinguishment guidance in IFRS 9) would produce a more reasonable accounting result. View A would produce a gain at the date of modification. However, interest expense would be higher over the remaining term of the modified liability because the adjusted carrying amount of the financial liability is amortized at the original effective interest rate. One Group member thought that since the entity has the ability to obtain financing from another lender, changing from an interest rate of LIBOR + 200 to LIBOR + 175 should reflect some degree of credit risk improvement. One Group

member raised the point that from a lender's accounting perspective, deciding whether this is a new loan or the continuation of an existing loan plays an important role in the assessment of significant credit risk related to the loan asset.

The Group's discussion highlights the fact that there appears to be some acceptance of all three views in practice, depending on facts and circumstances. It is important to note that the accounting treatment of the transaction costs incurred as part of the renegotiation differs depending on which view is applied.

Overall, the Group's discussion raises awareness about developments in global discussions on this topic since the beginning of this year. The Group recommended no further action to the AcSB on the basis that it is unlikely the IASB would redeliberate this issue further at this time.

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

IFRS 9: Lifetime Expected Credit Losses for Trade Receivables

IFRS 9 *Financial Instruments* changes the way that entities are required to apply provisions against trade receivables measured at amortized cost or at fair value through other comprehensive income. The model in IFRS 9 is forward-looking – meaning that entities are required to not only focus on whether a loss has occurred, but also whether a loss might occur in the future. This model is referred to as the “expected credit loss model”.

The Group discussed eight questions to highlight some of the factors to consider when applying the expected credit loss model to trade receivables.

Question 1 – Can expected credit losses be immaterial or even negligible, but never nil?

Expected credit losses are calculated in a mathematical sense. This means that there will always be some chance that cash flows will fall short of the contractual amounts. Hence, expected credit losses can never be nil.

The Group's Discussion

From a mathematical perspective, the model in IFRS 9 for calculating expected credit losses is based on taking the “probability of default”, and multiplying it by the “loss given default” and the amount of “exposure at default”. The effects of this multiplication could be that expected credit losses are small or close to nil.

One Group member thought that there could be situations, albeit rare, that expected credit losses could actually be nil (e.g., a 30-day receivable with a government agency that has a very strong credit rating). However, a few other Group members noted that even with sovereign nations, there is typically a probability of default notwithstanding that it could be low. Also, the probability of default could vary depending on the duration of the financial instrument.

The Group also talked about a situation involving a highly collateralized financial instrument. Although such an instrument may still have a probability of default, there is enough collateral to absorb the loss so that the measurement of expected credit losses could be nil. However, for trade receivables, it is typically not common to have collateral backing the instrument. An entity may also

have a general security agreement over the assets and having such an agreement could lead to the loss given default in that situation to be zero.

Group members observed that in applying the impairment model in IFRS 9, even if expected credit losses are determined to be negligible or nil, it is important that entities are able to demonstrate that they have done enough work to ascertain that outcome. This work includes ensuring sufficient controls are in place that would support an assessment of negligible or nil because credit risk factors can change over time.

Question 2 – What are some methods used to develop provision matrices?

IFRS 9 mandates a simplified approach to implementing an expected credit loss model for trade receivables without a significant financing component. Trade receivables with terms of one year or less would generally not have a significant financing component. An entity calculates the lifetime expected credit losses as its provision against such receivables.

Illustrative Example 12 in IFRS 9 discusses the use of a provision matrix as one possible way to implement the simplified approach. A provision matrix essentially applies an expected credit loss rate to every aging category of receivables, including the “current” category (see example below).

	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1-30 days past due	CU7,500,000	CU120,000
31-60 days past due	CU4,000,000	CU144,000
61-90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	CU580,000

IFRS 9 requires all categories of receivables to have a provision, even when they are not past due. The gross carrying amount of the receivables would be written off when the entity has no reasonable expectation of recovering anything for the financial asset. An entity should consider whether any receivables in the category of more than 90 days past due should be written off.

The expected credit loss model also applies to contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*, such as accruals of revenue or certain variable consideration. Therefore, the model applies even before a customer is invoiced.

In developing a provision matrix, an entity could consider doing the following:

- Gather information on the history of uncollectible amounts.

- Stratify receivables into different groups or segments before applying the provision matrix (e.g., by geographical regions, product type, customer ratings, collateral, and the nature of the customer such as wholesale versus retail). Proper stratification requires understanding the drivers of credit risk for underlying receivables. The stratification may go down to the individual customer level in some cases, but it is important to avoid double counting of losses in these situations.
- Understand the percentage of sales that historically makes its way to the category in which losses are typically experienced (such as the “more than 90 days past due” category) and the percentage that is lost from such receivables.
 - For example, an entity might conclude that 1 per cent of its sales will migrate to the “more than 90 days past due” category, and that, historically, 30 per cent of the face value of accounts in default is not collected. This historical pattern would imply that the starting point for the first aging category is 30 per cent x 1 per cent = 0.3 per cent. In other words, historically, 0.3 per cent of the dollar amount in current receivables has not been collectible. This same thought process is applied to each aging category to determine the historical loss ratio.

Establishing the historical loss rate is only the starting point. Entities also need to consider whether there is a long enough history and the historical data is similar enough to the current stratification criteria to assert that historical losses are a valid representation of the loss pattern.

The Group’s Discussion

The Group supported the analysis above in that provision matrices are developed by considering historical credit loss experience and aging history, and stratifying trade receivables based on factors that drive credit risk (e.g., industry, geographical regions, product type, customer ratings, collateral, and the nature of the customer such as wholesale versus retail).

Group members observed that materiality is a key factor considered by entities when deciding on how sophisticated the provision matrix must be for calculating expected credit losses. Several Group members noted that in practice, some entities have determined that regardless of how the population of trade receivables is stratified or segmented, the expected credit losses would not be material. As a result, a basic provision matrix such as the one shown in IFRS 9 is used.

Another Group member shared that in the banking industry, a roll-rate model is used for credit cards. The model takes into consideration terms of maturity and supplements the historical loss rate with forward-looking information. For trade receivables with typically a short term, a simple provision matrix may be sufficient. However, for longer-term items, the provision matrix will have to be more sophisticated to take into consideration other factors that would also drive credit risk.

Next, the Group discussed Questions 3 and 4 together.

Question 3 – Do entities look to external data in deriving the expected credit loss rate?

A newly established entity or an entity entering a new market may need to look to more than its own experience when determining expected credit losses. For example, an entity historically operating in

North America but expanding to Europe may not be able to rely on its historical North American loss rates for its European receivables. In such situations, the entity might consider industry loss rates instead.

Question 4 – How do entities incorporate forward-looking information into their provision matrices, and have entities used scenario analyses?

The question is how or to what extent the expected credit loss rate should be adjusted for differences between historical experience and future expectations. For example, an entity may look for a historical correlation between unemployment rates and the loss rate experience. If it finds such a correlation, an adjustment would need to be made to the historical rates to reflect the change in the forecasted unemployment rate.

It is important to note that establishing a linkage to macro-economic data has its complexities due to a potential lag in effect. For example, a rise in unemployment rate may not trigger an immediate increase in default for an electrical utility's customers because customers may prioritize paying electricity bills over other discretionary expenditures. Perhaps a prolonged period of increased unemployment may trigger a rise in loss rates. Therefore, such factors should be considered in the correlation analysis.

Entities might use scenario analyses to reflect different possible future outcomes for the correlated variable. Such adjustments to historical data are important because IFRS 9 does not rely exclusively on historical loss rates. It also requires informed estimates about the future.

The Group's Discussion

Several Group members observed that entities look at external data when calculating expected credit losses for trade receivables.

One Group member noted that segmentation of the trade receivables population is important, especially when the entity has long-term contracts in which the contract asset or the customer receivable is quite large. In such cases, performing an analysis by customer, including looking at the customer's credit rating or business operations, may be required to determine whether a larger expected credit loss amount should be recognized. Even if historical information indicates that losses have not been material, entities should incorporate forward-looking information and consider whether there are macro-economic factors that could suggest the industry has changed, such that relying on historical information is not sufficient.

Another Group member noted that some entities may use different loss rates based on the current economic environment (e.g., low-volatility versus high-volatility markets).

There could also be industries in which historical information is less relevant. For example, one Group member noted that for agricultural products, the prevailing commodity price is relevant in predicting the ability to collect from customers. Also, external factors such as weather could affect collectability, so those types of external data would be taken into consideration when designing the provisional matrix.

The Group noted that even when the history of losses is negligible, entities still need to consider forward-looking factors to demonstrate that the expected credit losses remain immaterial, for consistency with the underlying forward-looking impairment model in IFRS 9.

Next, the Group discussed Questions 5 to 8 together.

Question 5 – Are there other methods of implementing the simplified approach in practice?

Although IFRS 9 provides an example of a provision matrix, other methods are not precluded.

Question 6 – What are some additional considerations that entities should be aware of when implementing the simplified approach?

When looking at historical data, it is important to segregate losses relating to customer disputes or other discounts provided, from credit losses. Only losses due to credit risk would be within the scope of the IFRS 9 impairment provision. Other losses due to disputes, discounts, and/or inefficiencies are subject to guidance in IFRS 15, which should be applied prior to IFRS 9.

For income statement presentation, adjustments required under IFRS 15 will directly affect the revenue line, whereas IFRS 9 impairment provisions will generally affect an expense line.

Entities that have not historically tracked credit losses separately from other losses may need to re-examine the way data is collected and tracked to simplify the application of the provision matrix.

Incomes taxes may also be affected by the change in methodology for impairment as this change could create new or additional temporary differences.

Question 7 – Are entities experiencing any challenges with meeting the disclosure requirements for the expected credit loss model?

As a result of IFRS 9, IFRS 7 *Financial Instruments: Disclosures* requires more extensive disclosure about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses. Paragraph 35N of IFRS 7 allows entities to disclose some of the information based on the provision matrix when that simplified approach has been used.

Entities need to ensure their systems and processes are capable of generating the required quantitative information for the required disclosures.

Question 8 – Are entities experiencing any challenges when implementing controls pertaining to the simplified approach?

Since the IFRS 9 impairment model is substantially different from the IAS 39 impairment model and requires different estimates and judgments to be applied, new and different internal control procedures may be required.

Some controls may need to be implemented outside the financial reporting function (e.g., in the collections or credit management group) and systems may need to be changed to generate new analytical reports for deriving the required estimates of expected credit losses.

Also, controls might need to involve backward testing over time to compare between experienced losses and established provisions. This testing will help determine whether changes to the

provisioning methodology, such as additional correlations to macro-economic indicators or enhanced segmentation of customers, are required.

The Group's Discussion

Several Group members shared insights relating to the four questions above.

In terms of other methods of applying the simplified approach, an entity could adopt a specific-customer approach instead of developing a provision matrix, if it transacts with a small group of customers.

In terms of implementing the simplified approach, one of the challenges noted relates to distinguishing credit losses from losses due to customer disputes because this information was not previously tracked by entities. It is important to note that losses due to credit risk are separated from other losses because only credit losses are within the scope of IFRS 9.

To date, no significant disclosure challenges have been identified because most entities have only reported their first quarter financial statements under IFRS 9. The interim financial statements have only disclosed a description of the entity's accounting policy for expected credit losses.

From a controls perspective, entities are reminded to ensure that even if the expected credit losses for trade receivables are determined to be immaterial, proper controls need to be in place to ensure that changes in circumstances can be detected before a loss is incurred.

Overall, the Group discussed this topic to raise awareness of factors to consider under the new impairment model in IFRS 9 for trade receivables. The intent of the Group's discussion was to share insights on what approaches and challenges have been observed in practice. 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

Cryptocurrencies

At the January 2018 meeting, the Group recommended that the [issue](#) be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee.

The AcSB discussed the issue, which relates to the appropriate accounting model to apply for cryptocurrencies from a holder's perspective, and decided to raise the issue internationally. At the April 2018 meeting of the IASB's Accounting Standards Advisory Forum, the AcSB Chair shared the Group's discussion and other information gathered on this topic, to assist the IASB in understanding the developments in this area.⁶

The IASB is looking at whether action should be considered, such as starting a narrow-scope amendment, or adding a project to its research pipeline or its active research program. The IASB is expected to consider an analysis from its staff regarding the potential next steps on this topic at its

⁶ Members of the IASB's Accounting Standards Advisory Forum discussed the topic of cryptocurrencies during the agenda item on "Commodity loans and related transactions" (refer to the [summary](#) of the meeting).

July 2018 meeting. The AcSB staff is monitoring the IASB's discussions and will update the Group on any future developments.

It was also noted that in May 2018, CPA Canada issued a publication entitled "[An Introduction to Accounting for Cryptocurrencies](#)" that discusses possible approaches to account for cryptocurrencies under existing IFRS Standards. The publication also provides a brief summary of the tax implications of cryptocurrencies and supplemental guidance on determining their fair value.

IFRS 16 and IAS 38: Cloud Computing Arrangements

At the January 2018 meeting, the Group recommended that the [issue](#) be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee. The issue relates to the accounting for a cloud computing arrangement in which the customer pays fees to the supplier to access the supplier's hardware and application software.

The AcSB discussed the issue and decided to refer it to the IFRS Interpretations Committee. In June 2018, the AcSB sent a submission to the IFRS Interpretations Committee. The AcSB staff will monitor the IFRS Interpretations Committee's discussions and will update the Group of any future developments.

IFRS 16: Lease Incentive

At the January 2018 meeting, the Group recommended that the [issue](#) be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee.

The AcSB discussed the issue and agreed with the Group that there is a conflict between paragraph 24(b) and Illustrative Example 13 of IFRS 16 *Leases*. The AcSB connected with the IASB to determine what is the most efficient and effective way to bring clarity on this issue for stakeholders. The IASB discussed the issue at its May 2018 meeting and tentatively decided to propose amending Illustrative Example 13 as part of its next cycle of annual improvements to IFRS Standards (see [May 2018 IASB® Update](#)).

IFRS 16 and IAS 34: Variable Lease Payments

At the May 2017 meeting, the Group recommended that the [issue](#) be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee.

At the October 2017 meeting, the AcSB staff reported that the AcSB discussed the issue and agreed with the Group's observation that there is tension in the requirements between paragraph 38(b) of IFRS 16 *Leases* and paragraph B7 of IAS 34 *Interim Financial Reporting*. The AcSB directed its staff to monitor how practice is developing to determine the potential effect this issue could have on entities upon the adoption of IFRS 16.

At the June 2018 meeting, the AcSB staff reported that the AcSB had considered the additional information gathered by its staff on the issue. The AcSB decided to explore options with the IASB to determine the most efficient and effective way to bring clarity on this issue to help with implementation efforts in practice.

The IASB staff was invited to the Group's June 2018 meeting to share insights into the IASB's thinking on the interaction between IFRS 16 and IAS 34. The IASB staff noted that the IASB

developed the requirements in paragraph 38(b) of IFRS 16 as part of its development of the new leases standard. The IASB decided that variable lease payments linked to future performance or use would not be included in the lease liability, and paragraph 38(b) of IFRS 16 then specifies requirements on how to recognize those payments. The intent behind the decision meant that there would be no significant change in the requirements relating to those variable lease payments for entities currently applying IAS 17 *Leases* and then later adopting IFRS 16. Therefore, when the IASB considered what was already in paragraph B7 of IAS 34, it did not propose any change to that paragraph other than editorial changes to update the terminology to be consistent with IFRS 16. The illustrative example in paragraph B7 of IAS 34 continues to reflect the principle in paragraph 28 of IAS 34 that measurements for interim reporting purposes are made on a year-to-date basis.

OTHER MATTERS

Effective Dates for New Standards

The new financial instruments and revenue standards are in effect for most entities this year, and the new leases standard takes effect for annual reporting periods beginning on or after January 1, 2019. Stakeholders were reminded to also note several other changes that have recently come into effect, or will take effect next year. For example:

- The amendments to IFRS 2 *Share-based Payment* that relate to the classification and measurement of share-based payment transactions are effective for annual periods beginning on or after January 1, 2018. These amendments are intended to eliminate diversity in practice in three main areas, one of which is the classification of a share-based payment transaction with net settlement features for withholding tax obligations. The amendments clarify when entities are required to divide a share-based payment transaction into an equity-settled element and a cash-settled element.
- IFRIC 23 *Uncertainty over Income Tax Treatments* is effective for annual periods beginning on or after January 1, 2019. This new Interpretation clarifies how to apply the recognition and measurement requirements in IAS 12 *Income Taxes* when there is uncertainty over income tax treatments. Stakeholders were reminded of the requirements of this Interpretation.

Other amendments are effective for annual periods beginning on or after January 1, 2019. For a complete list, stakeholders were encouraged to visit the AcSB's website (i.e., [Effective Dates for New Standards – IFRS Standards](#)).

IFRS 17: Insurance Contracts

The AcSB completed its endorsement process and incorporated IFRS 17 *Insurance Contracts* into Part I of the CPA Canada Handbook – Accounting on March 1, 2018. The standard is effective for annual periods beginning on or after January 1, 2021. Earlier application is permitted for entities that also apply IFRS 9 and IFRS 15.

In addition, the Basis for Conclusions and Illustrative Examples issued by the IASB that accompany, but are not part of, IFRS 17 were added to Part I of the CPA Canada Handbook – Accounting on June 1, 2018.

(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 (e.g., providing advice on potential changes to IFRS Standards). The Group’s discussion of these matters supports 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).

Documents for Comments

At the June 2018 meeting, the Group provided input to the AcSB on key components of its [“Draft Framework for Reporting Performance Measures – Enhancing the relevance of financial reporting.”](#) The AcSB is seeking comments from stakeholders by September 17, 2018.

In addition, the Group discussed the IASB’s March 2018 Exposure Draft, [“Accounting Policy Changes \(Proposed amendments to IAS 8\),”](#) to assist the development of the AcSB’s response letter to the IASB. Comments were due to the IASB by July 27, 2018. Read the AcSB’s letter on the IASB’s [website](#).