IFRS® Discussion Group

Report on the Public Meeting

May 19, 2022

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.

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.

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ITEMS PRESENTED AND DISCUSSED AT THE MAY MEETING

Special Purpose Acquisition Companies (SPACs): Accounting for Warrants at Acquisition

The IFRS Interpretations Committee (the Interpretations Committee) received a request about how an entity accounts for warrants when acquiring a SPAC. A SPAC is a listed entity that is established to acquire a yet-to-be-identified target entity.

In the fact pattern described in the submission:

- A private operating entity acquires a SPAC that does not meet the definition of a business in IFRS 3 *Business Combinations* and has no assets other than cash.
- Before the acquisition, the SPAC's ordinary shares, which are determined to be equity instruments as defined in IAS 32 *Financial Instruments: Presentation*, were held by its founder shareholders and public investors. The SPAC also issued warrants to both its founder shareholders and public investors (the SPAC warrants).
- The private entity acquires the SPAC by issuing new ordinary shares and warrants in exchange for the SPAC's ordinary shares and the legal cancellation of the SPAC's warrants. The SPAC becomes a wholly owned subsidiary of the entity, and the entity replaces the SPAC as the entity listed on the stock exchange.
- The fair value of the instruments the entity issues to acquire the SPAC exceeds the fair value of the identifiable net assets of the SPAC.

The request asked whether the warrants issued to the SPAC shareholders are in the scope of IFRS 2 *Share-based Payment* as part of the equity instruments issued, or whether they represent a liability assumed by the acquiring company. If the warrants are classified as equity instruments, the request asked how they should be accounted for following the acquisition. The Interpretations Committee discussed this issue at its March 2022 meeting. Subsequent to the meeting, the Interpretations Committee published a tentative agenda decision on this issue.

The tentative agenda decision includes the following key points:

- Based on the fact pattern presented, the entity is the acquirer and the acquisition of the SPAC (acquiree) is the acquisition of an asset or a group of assets that does not meet the definition of a business.
- The entity considers the specific facts and circumstances of the transaction in assessing whether it assumes the SPAC warrants as part of the acquisition. If the facts and circumstances are such that the entity assumes the SPAC warrants as part of the acquisition, the entity applies IAS 32 to determine whether the warrants are financial liabilities or equity instruments. In addition, the entity considers the extent to which it accounts for the replacement of the SPAC warrants as part of the acquisition.
- The stock exchange listing service does not meet the definition of an intangible asset because it is not "identifiable" as described in paragraph 12 of IAS 38 *Intangible Assets*. Paragraph 2 of IFRS 2 states that "an entity shall apply this IFRS in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received." The Interpretations Committee observed that:

(a) the entity receives a stock exchange listing service for which it has issued equity instruments as part of a share-based payment transaction; and

(b) per paragraph 13A of IFRS 2, the entity measures the stock exchange listing service received as the difference between the fair value of the instruments issued to acquire the SPAC and the fair value of the identifiable net assets acquired.

- The Interpretations Committee tentatively concluded that the entity applies:

(a) IFRS 2 in accounting for instruments issued to acquire the stock exchange listing service; and

(b) IAS 32 in accounting for financial instruments issued to acquire cash and assume any liabilities related to the SPAC warrants because these instruments were not issued to acquire goods or services.

- If the entity concludes that the facts and circumstances are such that it does *not* assume the SPAC warrants as part of the acquisition, the entity issues both ordinary shares and warrants to acquire cash and a stock exchange listing service. In this case, the entity determines which instruments it issued to acquire the cash and which instruments it issued to acquire the listing service.

- IFRS Standards do not specify how to allocate the ordinary shares and warrants issued to acquire cash and stock exchange listing services. Therefore, the entity applies paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing and applying an accounting policy. Paragraph 10 of IAS 8 specifies, "In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is: (a) relevant to the economic decision-making needs of users; and (b) reliable." The Interpretations Committee noted that:

(a) an accounting policy that results in allocating all the warrants issued to the acquisition of the stock exchange listing service solely to avoid the warrants being classified as financial liabilities applying IAS 32 would not meet this requirement;

(b) the entity could allocate the shares and warrants to the acquisition of cash and the stock exchange listing service based on relative fair values of the instruments issued (i.e., in the same proportion as the fair value of each type of instrument to the total fair value of all issued instruments); and

(c) other allocation methods could be acceptable if they meet the relevance and reliability requirements in paragraphs 10-11 of IAS 8.

The Group considered the analysis included in this tentative agenda decision.

Issue 1: Practical challenges when applying an allocation approach to the consideration issued

Analysis

The tentative agenda decision introduces the notion of needing to determine which instruments were issued (shares or warrants under IAS 32 or IFRS 2) to acquire/assume specific items using an allocation approach. Allocating warrants partially to an IAS 32 transaction and partially to an IFRS 2 transaction may result in classifying the same instruments with the same terms partially as equity and partially as liability instruments due to the differences between how financial instruments are classified under each standard. For example, under IAS 32, warrants that may be settled other than

by the exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments would be classified as a liability. Under IFRS 2, the same warrants would be classified as equity.

The tentative agenda decision also does not address the practical difficulties that may arise with the subsequent accounting for the new warrants issued and allocated to the acquisition of cash and to the stock exchange listing service. For example, as warrants are exercised over time and where the terms and conditions of the exercised warrants and those of non-exercised warrants are the same, it may be difficult for the entity to distinguish which warrants are in fact exercised.

The Group's Discussion

Most Group members thought that the technical analysis in the tentative agenda decision had merit. However, several Group members noted that classifying consideration transferred (the warrants issued in the transaction) between IFRS 2 and IAS 32 depending on the underlying asset or service acquired results in several application challenges. One Group member questioned whether this allocation would result in relevant and reliable information. Furthermore, they thought that it may be confusing if warrants with the same features are accounted for as liabilities under IAS 32 or equity in accordance with IFRS 2. This Group member also thought that the liability presented on the balance sheet would not be a faithful representation of the full liability incurred by the entity. Another Group member noted that this situation highlights the broader issue that some instruments with the same features may be classified differently under IFRS 2 versus IAS 32. This Group member also agreed with the analysis in the tentative agenda decision that allocating all the warrants issued to the acquisition of the stock exchange listing service solely to avoid the warrants being classified as financial liabilities would not meet the requirements in paragraphs 10-11 of IAS 8.

Issue 2: Potential implications of the tentative agenda decision to other transactions and scenarios

Analysis

The approach proposed in the tentative agenda decision of allocating the consideration issued between IFRS 2 and IAS 32 transactions might also apply to the acquisition of a group of assets that is not a SPAC. Common examples include the acquisition of patents, intellectual property, receivables, payables and cash from a company in the life sciences industry. This may result in a change in practice as historically many entities applied judgment in determining whether IFRS 2 or IAS 32 applied instead of allocating between the two standards.

Another scenario that this tentative agenda decision might apply to is the issuance of warrants to key management personnel. It is common in the private equity industry to award key management personnel a variable number of shares in exchange for cash consideration, with the warrants being callable if the manager does not meet certain service conditions. The tentative agenda decision might apply in this scenario, given that a warrant is issued by the entity for cash proceeds and services to be received in the future.

The Group's Discussion

Several Group members agreed that this tentative agenda decision might also impact the accounting for other types of transactions involving the issuance of warrants to acquire a group of assets and liabilities. They indicated that these types of transactions are typically accounted for in their entirety under IFRS 2, whether or not the entity acquires any financial instruments as part of the transaction. These Group members also indicated that these types of transactions are common in Canada. Therefore, this tentative agenda decision, if finalized, could have a significant impact on Canadian entities.

One Group member commented that if this tentative agenda decision is finalized, entities would need to consider paragraphs 2-6A of IFRS 2 as to the scope of that standard when determining which assets and liabilities are included in the accounting for share-based payment transactions.

Another Group member noted that this tentative agenda decision might also apply to capital pool companies (CPCs) that issue replacement warrants or stock options. They said that most CPCs currently refer to the replacement share-based payment guidance in IFRS 3 *Business Combinations* when accounting for these types of transactions.

One Group member noted that the issuance of warrants to key management personnel in exchange for cash consideration might not fit into the fact pattern in the tentative agenda decision and that additional analysis would be required to assess the appropriate classification of instruments issued in such transactions.

Issue 3: SPACs accounted for as reverse takeover transactions (RTO)

Analysis

The Interpretations Committee's March 2022 Agenda Paper included an analysis of a fact pattern in which the SPAC acquisition is structured as a reverse acquisition. However, this scenario was not included in the tentative agenda decision because it was not the fact pattern submitted to the Interpretations Committee. Therefore, any diversity in practice that exists today might continue.

The Agenda Paper stated that if a SPAC acquisition is structured as a reverse takeover acquisition and the entity does not replace the SPAC warrants with new warrants, the SPAC warrants survive the transaction. Consequently, the entity assumes the SPAC warrants as part of the acquisition and recognizes any liabilities related to those warrants. The entity would therefore apply IAS 32 in determining whether the SPAC warrants are financial liabilities or equity instruments.

In practice, some entities consider the SPAC warrants part of the deemed consideration for the acquisition of the SPAC. Such consideration would be in scope of IFRS 2 to the extent that they relate to the acquisition of goods or services.

The Group's Discussion

One Group member noted that there is currently diversity in practice in how entities account for warrants upon the reverse takeover of a SPAC. This Group member indicated that some entities might rethink their accounting policy after considering the analysis in the Interpretations Committee's March 2022 Agenda Paper.

Most Group members agreed that the allocation approach highlighted in the tentative agenda decision would result in a change in practice for many Canadian entities when accounting for the issuance of warrants to acquire a SPAC, as well as other similar asset acquisition transactions. Several Group members also questioned whether this approach would result in the most relevant and reliable information. Therefore, the Group recommended that the AcSB respond to the Interpretations Committee's tentative agenda decision[1].

Financial Reporting Considerations of Hybrid-Work Arrangements

Many companies are currently transitioning to a hybrid-work model to provide their employees with more flexibility to work partly in the office and partly remotely. As a result, they are reconfiguring the

[1] The AcSB considered the feedback from the Group and submitted a comment letter on this tentative agenda decision on May 20, 2022.

use of real estate assets, such as vacating leased spaces, terminating leases early or reconsidering whether to renew leased spaces. The Group discussed some of these scenarios and their associated financial reporting considerations.

Fact Pattern for Issue 1

- Entity A is beginning to execute its hybrid-work model. Given that its employees are only expected to work on-site one to three days per week, Entity A has developed a plan to close three smaller regional offices and move the workforce into its largest building located in the downtown core. Employees will use a hoteling system to reserve a workspace in the office.
- Entity A had originally determined that it was reasonably certain it would renew the lease for one of their smaller regional offices for an additional five-year term after the initial term (Office 1).
- When nine months remain in the initial term of the lease, Entity A revises its budget and decides it will no longer renew the lease for Office 1.
- When six months remain in the initial term of the lease, Entity A gives notice to the landlord that it will not renew the lease beyond the initial term.
- Given employees are still working remotely at this time, Entity A has not begun to vacate the building.

Issue 1: When should Entity A reassess whether it is reasonably certain of exercising the renewal option for Office 1?

Analysis

Paragraph 20 of IFRS 16 *Leases* states that lessees only reassess whether a renewal option is reasonably certain to be exercised if there is a significant event or change in circumstances that is within the entity's control.

In determining whether a significant event has occurred that is within the entity's control, Entity A considers the list of examples in paragraph B41 of IFRS 16. One of these examples is the lessee's business decision that is directly relevant to exercising, or not exercising, an option (e.g., a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use (ROU) asset is employed). This example suggests the internal business decision made with nine months remaining in the initial lease term should trigger a reassessment.

For Entity A to conclude that it is reasonably certain that it will not exercise the renewal option, the entity will need to demonstrate that it has an economic incentive not to do so. Intention alone does not provide reasonable certainty. Since Entity A may change its decision to renew the lease without any direct economic consequences, it cannot conclude that it is reasonably certain that it will no longer exercise the renewal option when nine months remain in its original lease term.

Entity A should also reassess whether it is reasonably certain that it will exercise the renewal option when management notifies the landlord that it does not intend to renew the lease (i.e., with six months remaining in the lease term). In contrast to the decision made with nine months remaining, this decision cannot be reversed without economic cost. If Entity A decides it wants to retain a physical presence in the area, it will need to find a new space or negotiate with the landlord, both of which will have economic consequences. Therefore, Entity A can conclude that it is reasonably certain that it will no longer exercise the renewal option with six months remaining in the initial lease term.

The Group's Discussion

Most Group members agreed that determining whether it is reasonably certain that an entity will no longer exercise a lease renewal option is not a matter of intention alone. An entity should be able to demonstrate that it has an economic incentive not to renew the lease.

Most Group members agreed that Entity A in the fact pattern has demonstrated that it is reasonably certain that it will no longer exercise the renewal option when management notifies the landlord that it will not renew the lease (i.e., with six months remaining in the lease term). However, several Group members pointed out that there are several facts and circumstances that an entity needs to consider before it can conclude whether it is reasonably certain that it will not renew the lease with nine months remaining in the lease term.

Some Group members indicated that an entity should consider how formal its budgeting process is, and how easily it could change its budget. At many large organizations, budget preparation is a formal process involving careful planning, multiple approvals and communication across the organization. Once the budget is finalized, such organizations are reasonably certain that they will execute business decisions based on the budget. Changing the budget is rare, and involves the same degree of planning, approvals and communication across the organization. In contrast, many smaller organizations have a more flexible budgeting process. For these types of organizations, the internal business decision made with nine months remaining in the lease term might not be sufficient to conclude that the entity is reasonably certain that it will no longer renew the lease.

Some Group members noted that the communication strategy of the business decision not to renew the lease could also impact whether reasonable certainty exists. For example, the entity may have communicated this business decision to the employees who work out of this office. Reversing this decision might lead to employee retention issues as many employees might now prefer to work from home. One Group member pointed out that some companies have publicly communicated their intention to have a work-from-home model for the foreseeable future. Reversing this decision might result in negative economic consequences for the entity as it might create a negative public perception of the company.

One Group member indicated that an entity might consider indirect economic consequences of renewing the lease when assessing whether it is reasonably certain that it will no longer exercise the renewal option. For example, an entity might demonstrate that it experienced significant cost savings as a result of employees working from home during the pandemic. As a result, asking employees to permanently return to the office might not make economic sense for the company.

One Group member highlighted that paragraph B40 in the application guidance of IFRS 16 says that a lessee's past practice regarding the period over which it has typically used certain assets may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise an option. They indicated that this guidance might not apply going forward given that past practices may not reflect the entity's new business model.

Fact Pattern for Issue 2

- Same fact pattern as for Issue 1, except Entity A has another lease of office space that it plans to exit (Office 2), which has four years remaining in the initial lease term.
- Entity A and its landlord negotiate a termination penalty in exchange for allowing Entity A to exit the lease at the end of the year, three years before the original term was set to expire.

Issue 2: How should Entity A account for the termination penalty?

Analysis

Appendix A of IFRS 16 defines a “lease modification” as “a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.” Entity A’s arrangement to terminate the lease term early represents a lease modification because:

(a) the reduction of the remaining lease term from four years to one year represents a change in the scope of the lease; and

(b) the termination penalty represents a change in the consideration for the lease.

Entity A then applies paragraphs 44-46 of IFRS 16 to account for the lease modification. Given the term of the lease is reduced, the criteria in paragraph 44 of IFRS 16 are not met. As such, the lease modification should not be accounted for as a separate lease.

Entity A first recognizes the proportionate decrease in the ROU asset and the lease liability to reflect the reduction in the lease term. The difference between the amounts is recognized in profit or loss at the effective date of the modification.

Entity A then recognizes the difference between the remaining carrying amount of the lease liability and the modified lease liability as an adjustment to the ROU asset. This reflects the change in the consideration due to the termination penalty and the revised discount rate.

The Group’s Discussion

Group members agreed with the analysis.

One Group member pointed out that the analysis provided in the paper only applies when the termination penalty is not part of the original lease agreement. Some lease agreements can be quite lengthy, and it is important for entities to read through these agreements in detail to determine whether a termination penalty was prenegotiated. If the termination penalty is part of the original lease agreement, an entity would need to apply the reassessment guidance discussed in Issue 1 instead of accounting for it as a lease modification.

Some Group members indicated that the entity should also consider whether the asset is impaired as a result of the decision to terminate the lease.

Issue 3: Assume the same fact pattern as for Issue 2, but consider the accounting for the lease termination penalty from the perspective of the lessor that accounts for the lease as an operating lease.

Analysis

As required by paragraph 87 of IFRS 16, the lessor will account for this lease modification as a new lease at the date of modification.

The lease termination penalty will be included in the consideration for the lease that the lessor recognizes as rental income on a straight-line basis over the remaining term of the lease.

The Group’s Discussion

The Group agreed with the analysis.

One Group member observed that there is diversity in practice in terms of recognizing early termination penalties on operating leases when the new lease has a short duration. Some entities

recognize the termination penalty as soon as the termination is negotiated, some recognize it when the lessee vacates the premises, and some recognize it on a straight-line basis until the lessee vacates the premises. However, this diversity in practice might be due to materiality considerations rather than technical arguments under the literature.

One Group member indicated that entities should consider the collectability of the termination penalty when accounting for modifications to operating leases. If the termination penalty is not collectible, an entity should consider whether it should recognize a credit loss.

Another Group member pointed out that some lessors may have lease incentives on their balance sheet for which amortization may need to be accelerated in the event of an early termination.

Some Group members observed that the fact pattern assumes the new lease is an operating lease. In practice, an entity would need to assess whether the new lease is a finance lease.

Fact Pattern for Issue 4

- Same as Fact Pattern for Issue 2, except that Entity A also decides to vacate a single floor of the building located in the downtown core and will use a hoteling system that will reduce the need for office space. Entity A will continue occupying eight floors of the building.
- The common area maintenance (CAM) expense is a significant (25-30 per cent) proportion of the expense for the downtown office space. Entity A must continue to pay for all CAM expenses under the terms of the lease contract.
- Entity A has not elected to combine lease and non-lease components using the practical expedient permitted in paragraph 15 of IFRS 16. It will consider whether its ROU asset related to the one floor they intend to vacate is impaired under IAS 36 *Impairment of Assets*.

Issue 4: Should Entity A also consider whether there may be an onerous contract for the portion of the CAM expenses related to the one soon-to-be vacated floor?

Paragraph 10 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* defines an onerous contract as "a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it." The question is whether an onerous contract assessment can be performed at a level lower than the contract level.

View 4A – No, the unit of account under IAS 37 for the non-lease component is the contract as a whole

Proponents of this view think that the lease contract has two distinct units of account: the lease component and the non-lease component.

Typically, when assessing whether customer contracts are onerous under IAS 37, an entity looks at the whole contract rather than each component. The onerous contract assessment is therefore performed for the non-lease component as a whole.

View 4B – Yes, the unit of account under IAS 37 is each lease component

Proponents of this view think that the unit of account for the lease contract (including the non-lease component) is each floor. The entity assesses the lease component for impairment under IAS 36, and the non-lease component against the onerous contract guidance in IAS 37.

The unit of account for the impairment assessment and onerous contract assessment should be consistent.

View 4C – Accounting policy choice

Views 4A and 4B have merit, such that an accounting policy choice is available, to be applied consistently.

The Group's Discussion

Most Group members agreed with View 4A. They indicated that IAS 37 does not provide any guidance on breaking the contract down into components when performing the onerous contract assessment. They also thought that had the IASB intended for onerous contracts to be assessed at the component level, this would have been stated explicitly in the standard. Some Group members considered previous discussions on assessing onerous contracts under IFRS 15 *Revenue from Contracts with Customers*, and that the onerous contract assessment should be performed at the contract level, not at the performance obligation level. If the same logic is applied to IAS 37, this would support View 4A. One Group member also thought that it can be difficult to determine the CAM expenses for a particular floor, making it impractical to perform the onerous contract assessment at this level.

One Group member agreed with View 4B, indicating that it would be more consistent for the onerous contract assessment under IAS 37 to be done at the same level as the impairment assessment under IAS 36. Another Group member has seen arrangements in practice where an entity has a separate contract for each floor of the leased building. In such cases, this Group member thought that it would be appropriate to perform the onerous contract assessment for each floor.

Some Group members noted that entities should assess the specific facts and circumstances when determining the level at which to perform the onerous contract assessment. Although View 4A might be appropriate in some situations, entities should consider whether performing the assessment at a lower level is more appropriate in their specific scenario.

Overall, the Group's discussion raised awareness of the financial reporting considerations of hybrid-work arrangements. No further action was recommended to the AcSB.

IFRS 17: Matters for Non-insurance Entities

Non-insurance entities can issue insurance contracts. If an entity issues a contract that meets the definition of an insurance contract, it needs to apply IFRS 17 *Insurance Contracts* unless a specific scope exemption is met. This is the case for all entities, whether or not the entity is a regulated insurance company or financial institution.

The definition of an insurance contract in IFRS 17 has not changed significantly from that in IFRS 4 *Insurance Contracts.* However, the accounting under IFRS 17 can be significantly more complex than under IFRS 4. For example, while IFRS 4 permitted entities to unbundle the insurance element of contracts and apply IFRS 4 to those insurance elements, IFRS 17 applies to the whole contract, with limited exceptions, and has detailed measurement requirements.

IFRS 17 is mandatorily applicable for annual reporting periods beginning on or after January 1, 2023, with restatement of comparative periods. Therefore, entities that are not insurance companies should assess whether they have issued contracts which fall within the scope of IFRS 17.

The Group discussed the following issues pertaining to the application of IFRS 17 to non-insurance entities.

Issue 1: What is an insurance contract?

Analysis

Appendix A of IFRS 17 defines an insurance contract as, "A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Insurance risk is a non-financial risk transferred from the holder of the contract to the issuer. Examples of non-financial risk include the risk from damage to property or the risk of failure of a product or service that the entity sells to be fit for purpose. Non-financial risk becomes insurance risk when one party accepts this risk from another party.

Insurance risk is considered significant if a scenario has commercial substance in which the insurer could possibly suffer a loss on a present value basis and pay significant additional amounts beyond what would be payable if the insured event had not occurred. To have commercial substance, a scenario must have a discernible effect on the economics of the transaction.

The significance of insurance risk is assessed on a contract-by-contract basis. As a result, even if there is a minimal probability of significant losses on a portfolio or group of contracts, insurance risk can be significant for an individual contract. Paragraph BC67 of IFRS 17 clarifies that the assessment of significant insurance risk is made on a "present value" basis. This was not clearly specified in IFRS 4.

For a specified uncertain future event to exist, at least one of the following must be uncertain at the inception of the contract:

(a) the probability of an insured event occurring;

(b) when the insured event will occur; or

(c) how much the insurer will need to pay if the insured event occurs.

To meet the definition of an insurance contract, the issuer must be required to compensate the policyholder if the specified uncertain event occurs. That compensation may be in the form of cash or payments in-kind, such as repair services.

The following are arrangements that are likely to be accounted for as insurance contracts by the provider (issuer):

(a) warranties issued on products or services not sold by the entity;

(b) performance bonds;

(c) indemnity issued by a vendor in a sale of its business;

(d) guarantees of minimum profit; and

(e) contracts that guarantee a minimum level of output (e.g., electricity generated by a solar plant).

The Group's Discussion

Several Group members indicated that this discussion should help raise awareness of the approaching effective date of IFRS 17. They noted it should encourage non-insurance entities that have not yet evaluated their contracts under IFRS 17 to do so and assess any impact of the new standard on their financial statements. One Group member commented that some contracts that

were not in scope of IFRS 4 will be in scope of IFRS 17. Most Group members agreed this analysis provides a good reference for non-insurance entities to evaluate whether any of their contracts are in scope of the new standard.

Some Group members described examples of contracts in practice that might be considered insurance contracts. For example, some maintenance contracts that do not meet the fixed-fee service contracts scope exemption (discussed below) might be in scope. One Group member pointed out that some parent entities provide guarantees on behalf of a subsidiary. In such cases, the guarantee might be considered an insurance contract from the perspective of the parent's separate financial statements, but not for the consolidated group. An entity would consider the scope exemption for financial guarantee contracts in paragraph 7(e) of IFRS 17. Another Group member pointed out that entities in the public sector might consider whether certain laws and regulations create a substantive obligation that might be relevant when assessing whether an insurance contract within the scope of IFRS 17 exists.

Issue 2: Scope exemptions from IFRS 17

Analysis

The scope of IFRS 17 excludes various items that may meet the definition of an insurance contract, such as product warranties, financial guarantee contracts, fixed-fee service contracts, and credit card contracts. IFRS 17 does not apply to these contracts, provided certain conditions are met. Several of these scope exemptions are discussed in more detail below.

Warranties

Per paragraph 7(a) of IFRS 17, "an entity shall not apply IFRS 17 to warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer."

This scope exemption applies if the entity that manufactures or supplies the good or service is the same entity that provides the warranty. For example, a company manufactures printers and sells them directly to customers. At the time of sale, it gives customers a free one-year warranty to cover repairs due to manufacturing defects. In addition, at the time of sale, the customer can choose to purchase a two-year extended warranty to cover repairs for a fixed price.

In the above example the scope exemption would apply to both the basic and extended warranty because they are both offered by the manufacturer in connection with the sale of its goods.

Entities should be alert to circumstances where the legal entity, which is the manufacturer, dealer or retailer of the goods or services, is different from the legal entity that offers the warranty. For example, consider a variation of the above example where the extended warranty contract and related repairs is provided by a subsidiary. The scope exemption would be met in the group's consolidated financial statements because the group both sells the products and provides warranties on the products. However, from the perspective of the subsidiary's stand-alone financial statements, the scope exemption for warranties would not appear to be met because the subsidiary which provides the extended warranty is not the manufacturer, retailer or dealer of the products. The subsidiary may consider whether the extended warranty contract meets the fixed-fee service scope exemption (discussed below).

Fixed-fee service contracts

Per paragraph 8 of IFRS 17, an entity may choose to apply IFRS 15 *Revenue from Contracts with Customers* instead of IFRS 17 to insurance contracts that have, as their primary purpose, the provision of services for a fixed fee. The entity may make that choice on a contract-by-contract basis,

but the choice for each contract is irrevocable. This election is only available if the following conditions are met:

(a) the entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

(b) the contract compensates the customer by providing services, rather than by making cash payments to the customer; and

(c) the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

Entities need to apply judgment to determine whether the above conditions are met and, therefore, whether the contract would need to be accounted for under IFRS 17 or the choice of applying IFRS 17 and IFRS 15 is available. For example, if the contract is for vehicle repair and the pricing takes into account the nature of the vehicle (e.g., age, make, model) and/or the customer's history of repairs, this might reflect that the pricing for the contract is based on the individual risk assessment for that customer. Such a contract would likely not meet the first condition and would need to be accounted for under IFRS 17 because there are indicators of an individual risk assessment that reflects the nature of an insurance contract rather than a service contract.

Credit card contracts

Paragraph 7(h) of IFRS 17 says that "an entity shall not apply IFRS 17 to credit card contracts, or similar contracts that provide credit or payment arrangements, that meet the definition of an insurance contract if, and only if, the entity does not reflect an assessment of the *insurance risk* associated with an individual customer in setting the price of the contract with that customer (see IFRS 9 and other applicable IFRS Standards). However, if, and only if, IFRS 9 requires an entity to separate an insurance coverage component (see paragraph 2.1(e)(iv) of IFRS 9) that is embedded in such a contract, the entity shall apply IFRS 17 to that component."

If the insurance component of the credit card contract is a contractual term, rather than required by local legislation, IFRS 9 *Financial Instruments* requires an entity to separate and apply IFRS 17 to that insurance component. Credit card issuers will need to apply judgment to evaluate whether the insurance coverage component is a contractual term of the credit card contract, considering the specific terms of the contract and local legislation governing credit card protection.

The Group's Discussion

One Group member indicated that the analysis of the fixed-fee service contracts exemption as it relates to vehicle service contracts requires clarification. This Group member noted that it is common for entities providing vehicle service contracts to set pricing based on a standard risk matrix that considers a variety of factors, including the vehicle's make, model and year. Therefore, it needs to be considered whether this type of pricing structure reflects an assessment of the risk associated with an individual customer. This Group member also commented that this type of pricing structure does not reflect an assessment of the risk associated with an individual customer because the same standard risk assessment is applied to all customers. Therefore, an entity using this type of pricing structure should be permitted to apply the fixed-fee service contract scope exemption.

Entities are also encouraged to consider whether the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services. Many fixed-fee service contracts which are currently accounted for under IFRS 15 are expected to qualify for the exemption.

Fact Pattern for Issue 3

- Entity A owns three retail properties and has decided to outsource their maintenance to Entity B for a five-year term for a fixed fee.
- Under the terms of the contract, Entity B is required to provide repairs and maintenance services to maintain the properties to an agreed upon standard, based on their condition at the inception of the contract. Repairs required as a result of external events, such as fires, are covered by Entity A's property insurance.
- The fixed fee, which was set at the inception of the contract, is based on Entity B's inspection of each of the properties.
- Assume that the scope exemption for fixed-fee service contracts is not met.

Issue 3: Identifying whether a contract qualifies as an insurance contract

Analysis

Determining whether a contract qualifies as an insurance contract, as defined in IFRS 17, will likely depend on understanding the nature of a company's business, the industry in which it operates and the specific terms of the contract. When evaluating contracts, it will be important for entities to consider the substance of the arrangements.

When evaluating whether a contract qualifies as an insurance contract, entities might consider asking themselves:

(a) Does the contract require the issuer to compensate the holder if a specified future uncertain event occurs?

(b) Does the specified uncertain future event adversely affect the policyholder?

(c) Has there been a transfer of significant insurance risk?

Note the following with regard to the Fact Pattern:

(a) There is a specified uncertain future event because it is uncertain whether any particular repair will be required, when it will be required and how much any particular repair will cost. Compensation would be in the form of repair services provided to Entity A.

(b) The need for a repair would adversely affect the policyholder as it would have to be remediated.

(c) By fixing the fee, Entity A has transferred risk to Entity B regarding the expenses of maintaining the properties. The risk of future repairs is a non-financial risk that has been transferred to Entity B. Therefore, this is an insurance risk.

At contract inception, Entity B would need to assess:

- if the insurance risk is significant by considering all scenarios, with commercial substance; and
- if there is a scenario that has commercial substance in which the issuer has the possibility of loss on a present value basis. Insurance risk is significant if an insured event could cause the issuer to pay significant additional amounts in any scenario with commercial substance, even if that scenario is extremely unlikely. Judgment will need to be applied in making this determination.

Entity B would need to assess the significance of insurance risk on a contract-by-contract basis. Therefore, insurance risk could be significant, even if there is a minimal probability of loss arising across all of Entity B's property management contracts. A significant loss could arise on any one contract, including the one with Entity A.

If the insurance risk is significant, this contract qualifies as an insurance contract in the scope of IFRS 17.

The Group's Discussion

The Group agreed with the analysis.

Some Group members noted that the contract in the example does not meet the scope exemption for fixed-fee service contracts due to the uncertainty surrounding the costs of services provided. The cost of building materials and labour has fluctuated significantly since the start of the pandemic. If this trend continues, it could be difficult for Entity B to determine the cost of any maintenance work required.

Issue 4: Next steps

Analysis

It is recommended that non-insurance entities identify contracts that may qualify as insurance contracts well in advance of the effective date of the standard to ensure a smooth implementation.

When evaluating whether contracts are in scope of IFRS 17, entities should consider the following:

(a) What are the non-financial/insurance risks that the entity has accepted in its contracts?

(b) Are such contracts specifically excluded from the scope of IFRS 17?

(c) Does the acceptance of these risks result in an insurance contract as defined in Appendix A of IFRS 17?

If a contract qualifies as an insurance contract, within the scope of IFRS 17, the entity will need to apply the requirements of IFRS 17. This includes grouping contracts that share similar risk characteristics and are managed together into portfolios then disaggregating them into groups for measurement purposes.

There are three ways to measure groups of insurance contracts: the general model, the premium allocation approach and the variable fee approach. The three models have similar objectives: they provide a mechanism to release the premium received as insurance revenue over the coverage period, resulting in a liability representing the compensation for promising to fulfill future claims and service costs and earn a profit margin. In addition, all three models require entities to separately recognize and provide for claims when incurred. Each model can be complex and has its own detailed measurement and disclosure requirements. Therefore, entities that have issued insurance contracts will need to carefully consider these detailed requirements, as well as whether new systems, processes and controls are necessary to accurately perform these calculations and provide the required disclosures.

The Group's Discussion

The Group agreed with the analysis.

One Group member commented that determining whether a contract falls within the scope of IFRS 17 can be a significant judgment for some entities. If this is the case, the entity should consider

whether financial statement disclosure about such judgments is required. Another Group member commented that if a contract is an insurance contract within the scope of IFRS 17, it is possible that the pattern of income recognition may be similar to that in IFRS 15, but the disclosure requirements in IFRS 17 would be different.

Overall, the Group's discussion raised awareness of the impact of IFRS 17 on non-insurance entities. Given the new standard becomes effective from January 1, 2023, the Group recommended that the AcSB consider issuing material that steers preparers to existing publications from the IASB and the global accounting networks to help non-insurance entities understand the standard's requirements.

IFRS 2: Share-based Payment Awards with Variable Vesting Periods

Share-based payments are commonly subject to one or more specified conditions. For example, there might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price.

Paragraph 21 of IFRS 2 *Share-based Payment* states, "Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted." Therefore, for grants of equity instruments with market conditions, the services received from a counterparty (who satisfies all other vesting conditions) are recognized, irrespective of whether the market conditions are satisfied. Some examples of market conditions include:

(a) the entity must achieve a minimum share price by a specified date;

(b) the entity must achieve a total shareholder return target; or

(c) the entity's share price must outperform a share price index.

Where the length of the vesting period could vary, depending on when a performance condition is satisfied, paragraph 15(b) of IFRS 2 states that "the entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a *market condition*, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted; and it should not be subsequently revised."

The Group considered the pattern of expense recognition for a share-based payment scenario where a market condition is met earlier than expected.

Fact Pattern

- On January 1, 20X5, an employee receives a share-based payment award that vests if Entity A's share price hits a market performance condition ("target") either by December 31, 20X5 ("Date 1"), or by December 31, 20X6 ("Date 2").
- The employee could receive from zero to 100 per cent of the award depending on how much of the target is met. This means that:

  (a) the award has the potential to be 100 per cent vested on Date 1 if the full target is met on that date;

  (b) if the award does not fully vest on Date 1, the employee can earn any remaining amount on Date 2; and

  (c) the employee forfeits any amount not vested by Date 2.

- Assume that Entity A initially estimated that zero per cent of the award would be earned on Date 1 and 100 per cent of the award would be earned on Date 2. However, on Date 1, Entity A meets the full target. Hence, 100 per cent of the award is vested on Date 1.

Issue: Should Entity A accelerate the expense recognition when the target is met on Date 1, or should the company continue to recognize the expense over the estimated two-year vesting period?

View A – Expense recognition should be accelerated

Proponents of this view think that accelerating the recognition of the expense is consistent with the requirements in IFRS 2 to recognize expenses over an option's vesting period. This would reflect the fact that Entity A has received all the services to which it is entitled in exchange for the awards at the point that the market condition is met. Proponents of this view think that it would be inappropriate to consider any services to be received for an award after it has vested.

View B – Expense recognition should not be accelerated

Proponents of this view think that IFRS 2 specifically prohibits revision of the vesting period when a performance condition is met earlier than estimated. Therefore, Entity A should not accelerate the expense recognition, even though it might better reflect the economics of the share-based payment award.

The Group's Discussion

Several Group members indicated there is diversity in practice in how entities interpret the guidance in IFRS 2 on accounting for share-based payment awards with variable vesting periods when a market condition is met earlier than initially estimated.

Most Group members agree with View A that the expense should be accelerated in these situations. They think accelerating expense recognition results in more useful information for financial statement users and is more in line with the overall guidance in IFRS 2 to recognize an expense as vesting conditions are met. One Group member pointed out that accelerating the expense recognition is not a change in the initial estimate, but rather a reflection of the fact that the vesting condition was met. As such, they question whether accelerating the expense recognition conflicts with the requirements in paragraph 15(b) of IFRS 2, which only states that the estimate of the length of the expected vesting period should not be revised.

Some Group members agreed with View B in that the expense should not be accelerated. They noted that IFRS 2 specifically prohibits revision of the vesting period when a market condition is met earlier than estimated.

One Group member noted that entities should consider disclosing their accounting policy regarding this issue if these types of arrangements are material.

Overall, the Group's discussion raised awareness of how entities might interpret the guidance in IFRS 2 on accounting for share-based payment awards with variable vesting periods when a market condition is met earlier than initially estimated. The Group recommended the AcSB discuss this issue and determine what, if any, further action is required.

OTHER MATTERS

Recent IFRS® Interpretations Committee (the Interpretations Committee) Tentative Agenda Decisions

Special purpose acquisition companies (SPACs): Classification of public shares as financial liabilities or equity

The Interpretations Committee received a request about applying IAS 32 *Financial Instruments: Presentation* in relation to the classification of shares issued by a SPAC as financial liabilities or equity. The Interpretations Committee tentatively concluded that the matter described in the request is, in isolation, too narrow for the International Accounting Standards Board (IASB) or the Interpretations Committee to address. The Interpretations Committee noted that this matter is better suited to be addressed as part of the IASB's discussion on the Financial Instruments with Characteristics of Equity project. The Interpretations Committee nonetheless noted the importance of the SPAC disclosing information in the notes to its financial statements about the classification of its public shares.

SPACs: Accounting for warrants at acquisition

The Interpretations Committee received a request about an entity's acquisition of a SPAC. The request asked how the entity accounts for warrants on acquiring the SPAC. The Interpretation Committee tentatively concluded that the entity applies IFRS 2 *Share-based Payment* in accounting for instruments issued to acquire the stock exchange listing service and IAS 32 in accounting for instruments issued to acquire cash and assume any liabilities related to the SPAC warrants.

Quantity of the benefits provided under a group of annuity contracts

The Interpretations Committee received a request about a group of annuity contracts. The request asked how an entity determines the amount of the contractual service margin to recognize in profit or loss in a period because of the transfer of insurance coverage for survival in that period. The request included two methods of determining, for each contract in the group, the quantity of the benefits of insurance coverage provided in the current period and expected to be provided in the future.

The Interpretations Committee tentatively concluded that, in applying IFRS 17 *Insurance Contracts* to determine the quantity of the benefits of insurance coverage for survival provided under each annuity contract, a method based on

(a) the amount of the annuity payment the policyholder is able to validly claim (method 1) meets the principle in paragraph B119 of IFRS 17 of reflecting the insurance coverage provided in each period

(b) the present value of expected future annuity payments (method 2) does not meet the principle in paragraph B119 of IFRS 17 of reflecting the insurance coverage provided in each period

Rent concessions: Lessors and lessees

The Interpretations Committee received a request about a lessor's application of IFRS 9 *Financial Instruments* and IFRS 16 *Leases* in accounting for a particular rent concession. The rent concession is one for which the only change to the lease contract is the lessor's forgiveness of lease payments due from the lessee under that contract.

The Interpretations Committee tentatively concluded that the lessor accounts for the rent concession described in the request by applying:

(a) the impairment requirements in IFRS 9 to the operating lease receivable before the rent concession is granted, during the period in which it would consider whether and when to grant the concession;

(b) the derecognition requirements in IFRS 9 to forgiven lease payments that the lessor had included in an operating lease receivable on the date the rent concession is granted; and

(c) the lease modification requirements in IFRS 16 to forgiven lease payments that the lessor had not included in an operating lease receivable.

International Sustainability Standards Board's (ISSB) Exposure Drafts

The ISSB has published two Exposure Drafts for comment:

"IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*" (General Requirements Exposure Draft) sets out the overall requirements for an entity to disclose sustainability-related financial information about all its significant sustainability-related risks and opportunities, to provide the market with a complete set of sustainability-related financial disclosures.

"IFRS S2 *Climate-related Disclosures*" (Climate Exposure Draft) builds upon the recommendations of the Task Force on Climate-Related Financial Disclosures and incorporates industry-based disclosure requirements derived from Sustainability Accounting Standards Board Standards.

Canadian stakeholders are encouraged to submit their comments to the ISSB by July 29, 2022.