IFRS Discussion Group

Report on the Public Meeting

December 3, 2015

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

This document has been prepared by the staff of the AcSB and is a summarized version of the Group's discussions during the 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 IFRSs do not purport to be conclusions about acceptable or unacceptable application of IFRSs. Only the International Accounting Standards Board or the IFRS Interpretations Committee can make such a determination.

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ITEMS PRESENTED AND DISCUSSED AT THE DECEMBER MEETING

IAS 19: Change in Discount Rate Approach

The Group had previously discussed the issue, "IAS 19: Discount Rates," at its May 2015 meeting regarding the use of alternative approaches to a single weighted average or traditional discount rate approach. Group members noted that IAS 19 *Employee Benefits* does not appear to preclude the use of alternative approaches. Overall, Group members emphasized it is important to look at the underlying details of any model to understand if the calculations are aligned with the requirements in IAS 19 and if the model is being applied consistently from period to period.

For purposes of this discussion, the Group assumed that an acceptable alternative approach to a single weighted average discount rate is being adopted by an entity.

Issue: Should the change from a single weighted average or traditional discount rate approach to an alternative accepted approach be considered a change in accounting policy or a change in accounting estimate under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*?*

View A – Change in accounting policy.

The definition of "accounting policies" in paragraph 5 of IAS 8 includes "specific principles, bases, conventions and practices." Under this view, a change in the discount rate approach is a change in convention or practice. As a result, the methodology of determining the discount rate is considered an accounting policy decision and the change would be applied retrospectively unless it is impracticable to determine the period-specific effects.

Proponents of this view note that applying this change retrospectively provides useful information to users because the change would be made to all prior periods.

View B – Change in accounting estimate.

Under this view, a change in the discount rate approach is a refinement of a calculation or methodology rather than a change in accounting policy because the principle underlying the accounting has not changed. This view would be considered consistent with the guidance in paragraphs 33 to 34 of IAS 8 regarding changes in accounting estimates.

Proponents of this view note that if it is difficult to distinguish between a change in accounting policy and a change in accounting estimate, paragraph 35 of IAS 8 requires the change to be treated as a change in accounting estimate.

The Group's Discussion

Group members shared a common view that it would be appropriate to treat a change in the discount rate approach as a change in estimate (View B).

Some Group members considered the change to be a refinement of an input and observed that there are other areas in IFRSs where refinements are treated as a change in estimate. For example, under IFRS 13 *Fair Value Measurement*, a revision resulting from a change in valuation technique is accounted for as a change in estimate. Other Group members commented that if the change contained

characteristics of both an accounting policy and an estimate, guidance in paragraph 35 of IAS 8 would point towards a change in accounting estimate. Another point was made that if a change in the discount rate approach is considered an accounting policy change, a practical challenge would be applying the method without the use of hindsight.

One Group member thought it would be difficult to rule out either approach because paragraph 5 of IAS 8 defines accounting policies as "specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements." This member noted that using a single rate and moving to more granular rates is akin to a change in convention but agreed that retrospectively applying the approach without the use of hindsight would be difficult.

Group members emphasized the importance of disclosures to ensure users of financial statements have sufficient information to understand the method being used to determine the discount rate. They also emphasized the requirement to disclose discount rates used to determine the present value of the defined benefit obligation.

Although the relevant guidance in U.S. GAAP is different, the staff of the U.S. Securities and Exchange Commission concluded that they would not object to a registrant treating a change from a traditional, single weighted average discount rate approach to a disaggregated discount rate approach as a change in accounting estimate. However, robust disclosures would be needed to explain the effects of this change.

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

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

IFRS 2 and IFRS 3: A Reverse Takeover Involving Joint Control

IFRS 3 *Business Combinations* provides guidance on accounting for reverse acquisitions. However, existing IFRSs do not contain specific guidance in a situation when the reverse takeover involves acquiring an interest in a joint operation.

Fact Pattern:

- PUBSHELL is a public company trading on a Canadian stock exchange. The company is a shell entity and does not constitute a business under IFRS 3.
- PUBSHELL entered into an asset purchase agreement with Entity X to acquire a 50 per cent working interest in a group of assets referred to as XYZ. XYZ constitutes a business based on the definition in IFRS 3 because it is an interest in producing oil wells (including the rights, contracts, maps, records, tangible property and equipment used to drill and develop the land, petroleum in tanks or storage as at a specific date, and sale profits and royalties generated from sale of the hydrocarbons). XYZ is not a legal entity and PUBSHELL has acquired a 50 per cent undivided interest in XYZ. Prior to the transaction, Entity X was the 100 per cent interest holder.

- PUBSHELL's interest constitutes an interest in a joint operation based on the definition in IFRS 11 *Joint Arrangements* because there is joint control between Entity X and PUBSHELL and the joint arrangement does not involve a separate legal entity.
- The purchase price payable by PUBSHELL is comprised of a small amount of cash consideration and the remainder through the issuance of common shares in the capital of PUBSHELL.
- Upon completion of the acquisition, the shareholders of Entity X collectively own 85 per cent of the issued and outstanding common shares of PUBSHELL.
- The asset purchase agreement states that all of the directors and officers of PUBSHELL will resign and be replaced by nominees of Entity X (subject to the policies of the TSX Venture Exchange). Entity X will also appoint senior management of the combined entity through its control of PUBSHELL's Board of Directors.

Issue 1: Which party should be identified as the accounting acquirer in this transaction?

PUBSHELL and XYZ are the combining entities. Therefore, one of these entities needs to be identified as the acquirer in this transaction.

Existing IFRSs do not have specific guidance on the accounting for the acquisition of a joint operation. However, IFRS 11 was recently amended[1] to specifically state that the acquisition method in IFRS 3 applies when an entity obtains an interest in a joint operation that constitutes a business, provided that it does not conflict with guidance in IFRS 11. Paragraphs B13 to B18 of IFRS 3 provide guidance to assist entities in identifying the acquirer. Paragraph B19 of IFRS 3 further states, in part, that "a reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes on the basis of the guidance in paragraphs B13-B18."

The Group's Discussion

Although the transaction is not within the scope of IFRS 3 because PUBSHELL is not a business, the Group considered the criteria in paragraphs B15 and B16 of IFRS 3, by analogy, and agreed that the facts and circumstances would support that XYZ (i.e., the joint operation) is the accounting acquirer in the transaction. The rationale for this conclusion includes that:

- the shareholders of Entity X collectively own approximately 85 per cent of the issued and outstanding common shares of PUBSHELL upon completion of the acquisition;
- the relative size of Entity X is significantly larger as PUBSHELL did not operate any active business; and
- the composition of the governing body and senior management of the combined entity is determined by Entity X given the asset purchase agreement states that all the directors and officers of PUBSHELL will resign and be replaced by nominees of Entity X.

[1] Refer to *Accounting for Acquisitions of Interests in Joint Operations* (Amendments to IFRS 11). The amendments are effective for annual periods beginning on or after January 1, 2016 with earlier application permitted.

One Group member asked about the purpose of the transaction and it was clarified that although PUBSHELL did not operate an active business, XYZ is acquiring a stock exchange listing. Another question was raised regarding if there is a need to determine the ultimate shareholder in order to assess whether there is a joint operation. However, a view was expressed that IFRS 3 does not contain a requirement to do so. Even though the shareholders of Entity X collectively own 85 per cent of the issued and outstanding common shares of PUBSHELL, XYZ is still jointly owned by Entity X and PUBSHELL because both hold a 50 per cent working interest in the group of assets.

Issue 2: If XYZ is identified as the accounting acquirer, should the reverse takeover guidance be applied by analogy and the financial statements of PUBSHELL be prepared on the basis that it is a continuation of 50 per cent of XYZ (given that the interest in the assets acquired is not a legal entity and joint control was acquired)?

View 2A – Reverse takeover guidance can be applied, by analogy.

Under this view, it is appropriate to apply by analogy, the guidance in paragraphs B19 to B27 of IFRS 3 for reverse acquisitions. From the accounting acquirer's perspective, IFRS 2 *Share-based Payment* is applied because the acquisition is effected through a share purchase transaction. A listing expense would result. Proponents of this view consider this treatment to be consistent with the IFRS Interpretations Committee's agenda decision in March 2013 on the accounting for reverse acquisitions that do not constitute a business.

Paragraph B22 of IFRS 3 indicates that in a reverse take-over, the consolidated financial statements represent the continuation of the legal subsidiary, except for its capital structure. In the fact pattern presented, XYZ is not a legal entity and PUBSHELL acquires only a 50 per cent undivided interest in XYZ. Therefore, a portion of XYZ is considered to be carved out for the sale to PUBSHELL and, thus, a reporting entity.

Paragraph 21A of IFRS 11 states, in part:

> "When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business, as defined in IFRS 3 *Business Combinations*, it shall apply, to the extent of its share in accordance with paragraph 20, all of the principles on business combinations accounting in IFRS 3, and other IFRSs, that do not conflict with the guidance in this IFRS and disclose the information that is required in those IFRSs in relation to business combinations."

To reflect the extent of its share, the consolidated financial statements of PUBSHELL would be regarded as a continuation of 50 per cent of XYZ because XYZ is considered a business. IFRS 1 *First-time Adoption of International Financial Reporting Standards* would apply because the carved-out entity has not previously prepared any financial statements. The carve-out financial statements would reflect only the 50 per cent interest in the business that PUBSHELL owns, not the full assets of XYZ. Historical information would be considered available because these assets have operated in the past as part of a larger entity and IFRS 1 exemptions may provide some relief.

View 2B – Reverse takeover guidance cannot be applied by analogy.

Under this view, it is not appropriate to apply reverse takeover guidance by analogy, particularly with respect to the guidance contained in paragraphs B21 and B22 of IFRS 3 related to preparation and

presentation of consolidated financial statements. Proponents of this view argue that the fact pattern considered by the IFRS Interpretations Committee's agenda decision in March 2013 is different because it involves the acquisition of control rather than joint control and should not be applied by analogy.

The financial statements of PUBSHELL would not be regarded as a continuation of 50 per cent of XYZ because the reporting issuer (i.e., PUBSHELL) did not acquire control of XYZ, but rather only joint control. Thus, consolidated financial statements should not be prepared. PUBSHELL's financial statements would reflect the historical results of PUBSHELL and the acquisition of the joint operation (i.e., XYZ) at the date the acquisition closes, along with the expense that arises as a result of applying IFRS 2.

The Group's Discussion

There was some diversity in views as to whether PUBSHELL's financial statements should be prepared on the basis that it is a continuation of 50 per cent of XYZ.

One Group member who supported View 2A noted that because XYZ is classified as a joint operation, PUBSHELL's financial statements would be regarded as a continuation of 50 per cent of XYZ. However, another Group member raised a conceptual point that if XYZ is considered to be a joint venture, PUBSHELL's interest in XYZ would represent an equity method investment. In that case, it would not be reasonable to prepare PUBSHELL's financial statements as a continuation of 50 per cent of XYZ. However, the recognition and measurement principles of a reverse acquisition in IFRS 3 would still apply to PUBSHELL's share of the assets, but not the requirements in paragraphs B21 and B22 of IFRS 3 regarding the preparation and presentation of consolidated financial statements. Another Group member leaned more towards View 2B on the basis that the joint operation (i.e., XYZ) was formed at exactly the same time as the acquisition. Therefore, it did not seem reasonable to reflect joint control of XYZ in the previous period of PUBSHELL's financial statements because the assets were not jointly controlled at that time.

One Group member raised the point that the substance of the transaction is that the group of assets is going public so the result should be that PUBSHELL's financial statements are a continuation of 50 per cent of XYZ but not necessarily because of applying reverse takeover guidance by analogy. In essence, there should be no change to the measurement basis of the group of assets.

A representative from the Canadian Securities Administrators observed that this fact pattern is very distinct and each joint operation can be very unique and different. Therefore, other factors and underlying information of the joint operation should be taken into consideration to ensure the necessary disclosures, both in the financial statements as well as other continuous disclosure documents, are provided so that users can understand the effect of the transaction. Preparers are encouraged to consult with their regulators if there are presentation issues for which there may be alternative views.

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

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

IFRS 9: Impaired Assets on Transition

The IASB issued the final version of IFRS 9 *Financial Instruments* in July 2014. One of the specific transition requirements relating to impairment discusses the implications of applying the undue cost or effort exception when determining whether there is a significant increase in credit risk at initial application.

Paragraph 7.2.20 of IFRS 9 states:

> "If, at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 7.2.19(a) applies)."

Paragraph 7.2.19(a) of IFRS 9 states: "When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply the requirements in paragraphs 5.5.10 and B5.5.22–B5.5.24."

Paragraph 5.5.10 of IFRS 9 states: "An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date (see paragraphs B5.5.22–B5.5.24)."

Paragraphs B5.5.22 and B5.5.23 of IFRS 9 provide application guidance to assist an entity in determining whether a financial instrument has low credit risk at the reporting date (for example, the conditions that need to be in place to conclude that a financial instrument has low credit risk and an external credit rating is not required to reach that conclusion).

Paragraph B5.5.24 of IFRS 9 goes on to state, in part: "Lifetime expected credit losses are not recognised on a financial instrument simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date." An entity needs to determine if there was a significant increase in credit risk since initial recognition and decide whether lifetime expected credit losses are required to be recognized.

Fact Pattern:

- In 19X0, Lender X provided a loan to ABC Co. and the loan qualifies to be measured at amortized cost.
- At the date of initial application (T=1), Lender X could not, without undue cost or effort, determine whether there has been a significant increase in credit risk with respect to the loan to ABC Co. Thus, on transition to IFRS 9, Lender X recognized lifetime expected credit losses.
- At a later date (T=2), there is enough information to conclude that the loan has low credit risk. Pursuant to paragraph 7.2.20 of IFRS 9, Lender X now recognizes the impairment allowance at an amount equal to 12-month expected credit losses because paragraph 5.5.10 of IFRS 9 permits an entity to assume that "the credit risk on a financial instrument has not increased significantly since initial recognition" whenever the financial instrument has a low credit risk at the reporting date.

Issue: What is the amount of loss allowance that should be recognized at T=3 if the financial instrument's credit risk deteriorates such that it is no longer considered to be low credit risk?

View A – At T=3, Lender X measures the loss allowance at an amount equal to the lifetime expected credit losses, irrespective of whether Lender X obtains further information about the credit risk at the date of initial application.

Proponents of this view note that the financial instrument's loss allowance was initially measured at an amount equal to the lifetime expected credit losses using the transition exception in paragraph 7.2.20 of IFRS 9. Also, credit risk is not low at the reporting date.

Paragraph BC7.79 in the Basis for Conclusions on IFRS 9 states, in part:

> "The IASB acknowledged that if an entity uses an approach that is based solely on credit risk at the reporting date, then, when the entity is deciding the amount of expected credit losses to recognise, that approach will not allow the entity to consider the increases in credit risk that have occurred since initial recognition. Thus, entities would be required to recognise lifetime expected credit losses for a financial instrument for which the credit risk is not considered low, even if the instrument had been priced to reflect that risk and there has not been a significant increase in credit risk since initial recognition."

Based on the above, Lender X would only look to the absolute credit risk (i.e., either low or not low) at each reporting date when paragraph 7.2.20 of IFRS 9 was applied on transition, rather than to the change in credit risk.

View B – At T=3, Lender X would need to consider the guidance in paragraph B5.5.24 of IFRS 9 and assess whether there has been a significant increase (or decrease) in the credit risk since initial recognition.

Proponents of this view look to paragraph B5.5.24 of IFRS 9 to support that, even if the financial instrument's credit risk is no longer low, the loss allowance may still be measured at an amount equal to 12-month expected credit losses if there was no significant increase in credit risk since initial recognition.

Paragraph 7.2.20 of IFRS 9 indirectly references paragraph B5.5.24 of IFRS 9, suggesting that Lender X would need to consider whether there has been a significant change in credit risk (i.e., relative credit risk) for the financial instruments for which the transition exception was applied.

The Group's Discussion

Group members supported the view that at T=3, Lender X measures the loss allowance at an amount equal to the lifetime expected credit losses (View A) based on how the transition provision in paragraph 7.2.20 of IFRS 9 is worded.

One Group member noted that paragraphs BC7.72 and BC7.77 in the Basis for Conclusions on IFRS 9 would also support View A in that it is the absolute credit risk that should be considered. When undue cost or effort is required in determining credit risk, paragraph BC7.72 states, in part, that "the measurement of the loss allowance <u>should always be determined</u> only on the basis of whether the

credit risk is low at the reporting date." (emphasis added) Then paragraph BC7.77 states, in part, that "an entity would recognise lifetime expected credit losses, except if the credit risk was low, at each reporting date until the financial instrument was derecognised."

Another Group member observed that View B requires an entity to reassess, at each reporting date, whether it has information regarding changes in the credit risk since original inception. This view seems counter-intuitive as the entity elected to apply the exception at transition on the basis that it was unable to determine whether there has been a significant increase in credit risk since initial recognition without undue cost or effort. One Group member also pointed out that the exception results in a different accounting treatment than what would be required for financial instruments recognized after transition. This means looking at the absolute credit risk instead of the relative change in credit risk. That said, this kind of anomaly is not uncommon for new standards and seems to have been contemplated by the IASB based on the wording of paragraph BC7.79 of IFRS 9.

Group members commented that the hurdle is relatively high for entities to support management's assertion that undue cost or effort is required when determining whether there has been a significant increase in credit risk since initial recognition.

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

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

IFRS 15 and IAS 18: Bill-and-hold Arrangements

IFRS 15 *Revenue from Contracts with Customers* replaces IAS 18 *Revenue* and IAS 11 *Construction Contracts* and is effective for annual reporting periods beginning on or after January 1, 2018.

IFRS 15 contains specific application guidance on the accounting for bill-and-hold arrangements and a non-authoritative illustrative example.

Paragraph B79 of IFRS 15 states:

> "A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product or because of delays in the customer's production schedules."

Paragraphs B80 to B82 of IFRS 15 require that an entity determine when it has satisfied its performance obligation to transfer the product and sets out the criteria that must be met in order for an entity to recognize revenue for the sale of a product on a bill-and-hold basis. An entity is also required to allocate a portion of the transaction price to each performance obligation.

IAS 18 differed from IFRS 15 in that it did not contain specific guidance on bill-and-hold arrangements, but there was an illustrative example in IAS 18 that provides non-authoritative guidance.

Fact Pattern:

- A customer has requested an entity to provide custodial services. The goods are not specifically customized for the customer, but are stored in a special storage room. The entity typically does not provide custodial services unless a customer has ordered goods.
- The contract does not state a price relating to the custodial services and the total transaction price does not change regardless of how long the goods are stored at the entity's premise.
- The storage room is locked and equipped with cameras and alarms and only certain designated employees have access to the room. The entity's policy is that once goods are placed in the storage room, they are "reserved" for the specific customer and, thus, cannot be used or directed to another customer. However, the goods in the storage room are not specifically identified as belonging to a particular customer. There are controls in place to ensure compliance with the entity's "reservation" policy.
- Upon pick up of the goods, a designated employee tracks the customer purchase order in the system and identifies the specific items pertaining to the customer's order by the product description. The employee then enters the storage room, locates the described goods and provides them to the customer.
- Although the items are not specifically identified for the customer who has requested the custodial service, the total inventory count of a specific item would agree to the total quantity in the system.

The Group discussed the following three issues together in relation to the fact pattern:

Issue 1: Is the custodial service a separate performance obligation?

Paragraphs 22 to 30 of IFRS 15 contain the guidance for identifying performance obligations.

View A – Yes, the custodial service is considered a separate performance obligation.

Proponents of this view think that the custodial service is a separate performance obligation under IFRS 15 because there are economic benefits generated in the form of cost savings for storage space for the customer. The custodial service can be separately identified from the other promises in the contract since the customer specifically requested the entity to provide this service. Other goods and services delivered through the contract are not affected by the custodial service. Therefore, the service is not considered dependent or interrelated with the other goods or services in the contract.

View B – No, the custodial service is not considered a separate performance obligation.

Proponents of this view think that the customer cannot benefit from the custodial service without having ordered the goods being stored. Thus, the custodial service is highly dependent and interrelated with the goods ordered in the contract. Also, the entity does not provide custodial services unless a customer has ordered goods. This fact suggests that the service is not distinct from other promises in the contract.

Issue 2: Assuming the custodial service is considered a separate performance obligation under IFRS 15, how should the transaction price be allocated to the custodial service?

Paragraph 73 of IFRS 15 states, in part, that the allocation objective is to allocate “an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.”

Paragraph 74 of IFRS 15 states, in part, that “an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative stand-alone selling price basis.”

Paragraphs 76 to 80 of IFRS 15 set out the guidance for allocating the transaction price based on a stand-alone selling price. These paragraphs discuss how the best evidence of a stand-alone selling price is an observable selling price and what the suitable methods are for estimating the stand-alone selling price if the price is not directly observable. Paragraph 79 of IFRS 15 provides guidance on the suitable methods for estimating the stand-alone selling price of a good or service (i.e., the adjusted market assessment approach, expected cost plus a margin approach, and the residual approach).

Issue 3: Given the goods are not customized for the customer and how the entity stores the goods in the fact pattern, would the entity be able to recognize revenue based on the criteria outlined in paragraph B81 of IFRS 15?

The bill-and-hold criteria included in paragraph B81 of IFRS 15 are more detailed than the criteria in the illustrative example in paragraph IE1 of IAS 18.

Paragraph B81 of IFRS 15 states:

> “In addition to applying the requirements in paragraph 38, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:
>
> (a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
>
> (b) the product must be identified separately as belonging to the customer;
>
> (c) the product currently must be ready for physical transfer to the customer; and
>
> (d) the entity cannot have the ability to use the product or to direct it to another customer.”

Paragraph IE1 of IAS 18 stated:

> *“'Bill and hold' sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.*
>
> Revenue is recognised when the buyer takes title, provided:
>
> (a) it is probable that delivery will be made;
>
> (b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
>
> (c) the buyer specifically acknowledges the deferred delivery instructions; and
>
> (d) the usual payment terms apply.
>
> Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.”

In particular, instead of being "identified and ready for delivery" as per paragraph IE1(b) of IAS 18, the goods must be "identified separately as belonging to the customer" and the entity "cannot have the ability to use the product or to direct it to another customer" according to criteria (b) and (d) in paragraph B81 of IFRS 15. In this fact pattern, since the goods are not customized for the customer, applying the guidance in IFRS 15 may be more complex.

The Group's Discussion

With respect to Issue 1, Group members supported that the custodial service is considered a separate performance obligation (View A) and observed that the proposals in the IASB's Exposure Draft, "Clarifications to IFRS 15," would further support this view.

In considering the approach to take in allocating the transaction price (Issue 2), Group members expressed that it would be difficult to rule out any of the approaches outlined in paragraph 79 of IFRS 15. The adjusted market assessment approach would seem more common because it would be unusual for an entity to not be able to obtain some element of observable input with respect to the price of storage in the market. Paragraph 78 of IFRS 15 requires an entity to maximize the use of observable inputs in estimating the transaction price. One Group member observed that if an entity concludes that the expected cost plus margin associated with providing the custodial service is immaterial, sufficient support is needed because such an approach would result in full revenue recognition upfront and be inconsistent with the concept of using maximizing observable inputs. Therefore, considering the transaction price of the custodial services to be immaterial should not be viewed as a default position. Other approaches permitted under IFRS 15 may be more appropriate.

The Group also discussed how an entity would measure the progress towards complete satisfaction in this fact pattern. One Group member noted that management would make its best estimate of how long the goods would be stored for and use that estimate as a basis for measurement to completion. Another Group member commented that if a high level of uncertainty exists around what the custodial period is, this could suggest that revenue cannot be reliably measured.

With respect to Issue 3, Group members noted that since the goods are not tagged specifically for a particular customer in the fact pattern described, it would be difficult to satisfy the bill-and-hold criteria despite being segregated from other inventory. A customer would not be able to insure its goods if not distinctly identified. Group members thought that the criterion of an entity not being able to use the product or direct it to another customer in paragraph B81(d) of IFRS 15 presents a very high hurdle. Simply tagging and segregating the goods may not be sufficient if the ability to substitute still exists. Highly customized goods would help limit the ability to interchange products. For identical goods, it would be more difficult to satisfy this criterion. However, one Group member noted that if unique serial numbers were used and also specified in the contractual arrangement with the customer, this may help limit the ability to substitute the goods. If an independent security service was used to secure the specified good, this may also constrain the entity's ability to use or direct it to another customer. It was noted that the criterion in paragraph B81(d) of IFRS 15 is similar to the guidance of the U.S. Securities and Exchange Commission.

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

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

IAS 32 and IAS 39: Changes to Convertible Debt

There are situations when an entity would negotiate with lenders to restructure its convertible debt (for example, when an entity is experiencing financial difficulty).

A restructuring of convertible debt may result from a change or modification to the key terms of the convertible debt or through an exchange of old convertible debt with new debt on similar or substantially different terms. An entity needs to determine whether the change in key terms or exchange of the debt represents an extinguishment or modification of the original debt in order to apply the correct accounting treatment in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 40 of IAS 39 states:

> "An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability."

Furthermore, paragraph AG62 of IAS 39 states:

> "For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability."

Therefore, if the exchange or modification is accounted for as an extinguishment, the effect is recognized immediately. Otherwise, the effect of the exchange or modification would be recognized prospectively. The challenge around applying this guidance in practice is that it does not explicitly address modifications of debt with conversion options.

Fact Pattern:

- Entity X has issued a convertible debt instrument for $1,000,000. The conversion option meets the "fixed-for-fixed" condition in IAS 32 *Financial Instruments: Presentation* and, thus, is accounted for as an equity component of the instrument. A liability is recognized for the host debt component.

- At the end of year 1, the convertible debt instrument has a fair value of $900,000 and the host debt instrument has a fair value of $860,000. For simplicity, the amount of $860,000 is also assumed to be the present value of the remaining cash flows of the host debt.
- Due to the decrease in Entity X's share price, Entity X and the convertible debt holders renegotiate the terms of the arrangement. The debt holders agree to exchange their convertible debt for new non-convertible debt with a fair value of $900,000. For simplicity, the amount of $900,000 is also assumed to be the present value of the cash flows under the new terms (including any fees paid net of any fees received) discounted using the original effective interest rate.
- The original conversion option feature was substantial (i.e., not of insignificant worth).

Issue 1: When replacing the convertible debt with a non-convertible debt instrument prior to maturity of the original instrument, what approach is Entity X required to use in determining whether the change should be accounted for as a modification or extinguishment?

View 1A – Entity X applies the 10 per cent quantitative test only to the debt component.

Under this view, Entity X determines if the new non-convertible debt is substantially different by applying the derecognition requirements in IAS 39 to the financial liability component only.

Proponents of this view note that IAS 39 does not provide derecognition guidance for the equity component and, thus, there is no requirement to look at any changes to a non-financial liability component of the convertible debt (i.e., the conversion option classified as an equity component). Furthermore, paragraphs 40 and AG62 of IAS 39 do not address considerations related to changes in the instrument that affect the other characteristics or risk profile beyond its cash flows.

In this fact pattern, the change in cash flows does not exceed 10 per cent. Therefore, the change in the terms is accounted for as a modification of the original convertible debt.

View 1B – Entity X applies the 10 per cent quantitative test to the debt component and applies qualitative factors to the whole instrument.

Under this view, Entity X determines if the new non-convertible debt is substantially different by applying the derecognition requirements to the whole instrument.

Proponents of this view note that neither paragraph 40 nor paragraph AG62 of IAS 39 prohibit an entity from looking to qualitative factors in determining whether the change is substantial. Rather, an entity is always required to review the 10 per cent quantitative cash flow test. In addition, if the characteristics or risk profile of the new debt instrument have changed substantially from the original instrument, then the change is accounted for as an extinguishment of the original debt.

In this fact pattern, the original conversion option is removed. Even though the net present value of the cash flows under the new terms is less than 10 per cent different from the discounted present value of the remaining cash flows of the original liability, Entity X would still account for the exchange as an extinguishment. This approach is on the basis that the changes have resulted in the instrument as a whole to be substantially different from the original instrument.

View 1C – Entity X has an accounting policy choice whether to review and apply qualitative factors to the whole instrument.

Under this view, an accounting policy choice exists as to whether the derecognition requirements in IAS 39 are applied on the debt component only or whether testing is performed on the whole instrument.

The Group's Discussion

Most Group members supported the view that both the 10 per cent quantitative test and qualitative factors should be reviewed to determine whether the change would be accounted for as a modification or extinguishment (View 1B). Group members noted that it would be difficult not to consider the removal of the conversion option when assessing whether the characteristics or risk profile have changed substantially. Further, from a holder's perspective, it would be difficult to argue that the original instrument has not changed given the loss of a conversion option.

However, some Group members did not necessarily agree with the conclusion in View 1B in this fact pattern (i.e., that Entity X would account for an exchange of the liability as an extinguishment). They pointed out that although the conversion option is removed, further analysis is required. For example, if the conversion feature was deeply out of the money with no prospect of being of value in the future when the terms of the instrument were amended, then accounting for the change as a modification may be appropriate. In this circumstance, the conversion option would not be a substantive feature at the date of modification.

One Group member supported the view that an accounting policy choice exists (View C) on the basis that guidance in IAS 39 is not explicit on either approach.

Issue 2: If the exchange results in a substantial change in terms and, therefore, is accounted for as an extinguishment of the existing convertible debt (i.e., View 1B), what is the appropriate accounting for allocating the proceeds to the debt and equity components?

View 2A – Gains or losses are allocated to the debt and equity portions.

A gain or loss should be recognized on the extinguishment of the convertible debt in accordance with paragraph AG33 of IAS 32. A part of the new non-convertible instrument replaces the debt component of the convertible debt and a part of the new non-convertible instrument replaces the equity component of the convertible instrument.

Under this view, the consideration paid is allocated to the debt and equity components of the existing convertible debt at the date of the transaction using the same allocation method as on initial recognition. Any difference between the new debt that is allocated to extinguishing the debt component and the carrying value of the host debt is recognized as a gain or loss through profit or loss in accordance with AG34 of IAS 32. The new debt that is allocated to extinguishing the equity conversion component does not result in a gain or loss. Instead, any difference between this amount and the carrying value of the conversion option is taken directly to equity in accordance with AG34 of IAS 32.

View 2B – Gains or losses are allocated to the debt portion only and recognized through profit or loss.

Under this view, if Entity X were to apply the derecognition requirements to the debt component only, any difference between the fair value of the new debt instrument and the carrying value of the existing debt instrument is recognized in profit or loss in accordance with AG34 of IAS 32. The extinguished conversion option does not give rise to a gain or loss. The conversion option continues to be recognized within equity.

The Group's Discussion

Some Group members supported the view that any gain or loss should be allocated to the debt and equity portion (View 2A) because if the change was considered an extinguishment in this fact pattern, this meant that the conversion feature was a substantive feature at the date of modification. Thus, it would be reasonable that a portion of the gain or loss should be allocated to the equity component. However, a few Group members thought it would be difficult to rule out the approach under View 2B because the change is not considered an early redemption of the convertible debt or it could be viewed as analogous to letting the conversion option expire. Therefore, these Group members thought there could potentially be diversity in practice in this area. One Group member pointed out that there could also be earnings per share implications. Another Group member questioned whether there should be symmetry in accounting between the issuer and the holder of such instruments because it is not clear from the guidance in IAS 39.

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.

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

IAS 1: Disclosing Significant Accounting Policies

The challenge of disclosure overload is recognized by the IASB and many others in the financial reporting world. There are publications[2] that highlight how a growing volume of disclosures can be perceived to inhibit a user's ability to identify and understand the most important information. The IASB is undertaking a multi-part Disclosure Initiative to address this challenge.

In considering what an entity should disclose as part of its significant accounting policies, IAS 1 *Presentation of Financial Statements* provides the relevant guidance.

Issue: Is an entity required to disclose all significant accounting policies?

View A – Yes, an entity is required to disclose all significant accounting policies.

Proponents of this view interpret paragraph 10 of IAS 1 to require all significant accounting policies to be disclosed on the basis that it cannot be assumed that all users are familiar with the requirements of IFRSs.

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[2] An example of such a publication would be CPA Canada's "Five Steps to Simplifying Financial Statements – Today."

View B – Yes, an entity is required to disclose all significant accounting policies. The disclosure should focus on accounting policies in which the entity has explicit or implicit discretion to select or develop its policy.

Proponents of this view also interpret paragraph 10 of IAS 1 to require the disclosure of all significant accounting policies, but the guidance in paragraphs 119 and 121 of IAS 1 are also taken into consideration. These two paragraphs suggest that an entity should focus on disclosing particular accounting policies over which it has discretion.

An example of such a particular accounting policy would be when an entity selects from alternatives (i.e., a policy choice) allowed in IFRSs. Another example would an accounting policy that is not specifically required by IFRSs, but an entity selects and applies it in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

View C – No, an entity is not required to disclose all significant accounting policies. Only the most significant accounting policies should be disclosed.

Under this view, materiality should be taken into consideration in determining which significant accounting policies should be disclosed.

Paragraph 119 of IAS 1 states, in part: "In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in reported financial performance and financial position." Proponents of this view interpret this paragraph as requiring disclosure of only the most significant accounting policies.

View D – No, an entity is not required to disclose all significant accounting policies. Disclosure should be limited to only those policies in which the entity has explicit or implicit discretion to select or develop.

Under this view, if the requirements of a particular IFRS are direct, clear and without choice, summarizing such requirements would detract from the usefulness of financial statements and be considered redundant (assuming the entity has made an explicit and unreserved statement of compliance with IFRSs).

The Group's Discussion

The presenter clarified that the issue submitted was in the context of existing requirements as at January 1, 2015. However, the views presented take into consideration amendments to IAS 1 that become effective for annual periods beginning on or after January 1, 2016.

Group members supported the view that an entity is required to disclose all significant accounting policies (View A). Financial statements are prepared for a wide range of investors that can have varying knowledge of IFRSs. Only disclosing accounting policies when a choice is made by an entity places heavy reliance on users to be well-versed with the requirements in IFRSs. It is essential that a user has sufficient information in a set of financial statements to understand all of the significant accounting policies adopted by an entity. Providing a description of the accounting policies directly in

the financial statements also communicates to a user what components of the standards are significant to the entity.

One point was raised regarding the intent of paragraph 121 of IAS 1, which states, in part: "An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material." This paragraph could suggest that more disclosures may be needed in certain circumstances even if the amounts are not material in order to enhance a user's understanding of an entity's operations.

Group members acknowledged the issue that some entities include boilerplate disclosures that are not geared to their own circumstances. Therefore, it is important that entities not only describe accounting policies that are significant to its operations, but also tailor the description to explain how the policies are applied to the entity's operations so that it provides useful, concise information to users.

Group members also briefly discussed what disclosures might be required when a new accounting standard is issued but not yet effective as well as when such a standard is adopted. The focus was specifically on whether all new standards had to be disclosed in the notes to the financial statements, or only those that are relevant to the entity; (for example, a retail bank would not normally discuss the impact of a new agriculture standard). A few Group members noted that while there may be diversity in practice, the general view was that only the new standards relevant to the entity are required to be disclosed.

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

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

Recent Regulatory Publications on Financial Reporting Matters

Representatives from the Canadian Securities Administrators (CSA) provided a high-level summary of the following:

- results from the recent Continuous Disclosure Review Program;
- changes to the disclosure requirements for venture issuers; and
- upcoming changes related to the CSA staff guidance on non-GAAP measures.

Continuous Disclosure Review Program

The goal of the program is to improve the completeness, quality and timeliness of continuous disclosure provided by reporting issuers in Canada. CSA Staff Notice 51-344, "Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2015" contains a summary of the 280 full reviews and 778 issue oriented reviews that were conducted.

With respect to financial statement disclosures, some recurring areas of concern include operating segments, business combinations, fair value measurement and impairment of assets. With operating segments, it was noted that there are still issues with entities meeting the general requirements in IFRS 8 *Operating Segments*. In particular, there are issues related to disclosing information about

geographic areas, explaining who the chief operating decision-maker is and providing sufficient details as to how operating segments are aggregated. In terms of business combinations, issuers are still struggling to properly identify intangible assets, thus resulting in significant amounts of goodwill being recognized. For fair value measurements, the disclosure requirements are still relatively new and, thus, valuation technique and input disclosure information can all be improved. With respect to impairment testing, some issuers are not providing sufficient disclosure around how the amount of an impairment loss is determined, or the method and key assumptions used in the impairment test.

The review also uncovered some recurring issues related to the Management Discussion and Analysis (MD&A), which in turn has an effect on the financial statement disclosures. The issues include insufficient discussion on liquidity, capital resources and results of operations, unclear identification of forward-looking information and inadequate disclosure around the use of non-GAAP measures. Further areas of concerns include disclosures around real estate investment trust distributions, related party transactions with respect to identifying the related party and discussing the business purpose, and inconsistent messages regarding the effectiveness of controls between the CEO and CFO certifications and the MD&A.

New Tailored Disclosure for Venture Issuers

The most significant change regarding disclosures for venture issuers is that quarterly highlights can be prepared instead of the full interim MD&A. Other areas of change include the threshold used in the significance test for business acquisition reporting, shorter executive compensation disclosure and reduced prospectus disclosure from three years to two years. There are also some changes to audit committee requirements and the mineral property section in the Annual Information Form to align with National Instrument 43-101, *Standards of Disclosure for Mineral Projects*.

Planned Amendments to Guidance on Non-GAAP Measures

With the recent amendments to IAS 1 *Presentation of Financial Statements* that are effective for annual periods beginning on or after January 1, 2016, there are some duplicate requirements contained in CSA Staff Notice 52-306 (Revised), "Non-GAAP Financial Measures and Additional GAAP Measures." Some of those will be removed (i.e., guidance on subtotals presented in financial statements) in light of the new requirements in amended IAS 1. There will also be revisions to the definition of "non-GAAP measure", additional guidance on naming a non-GAAP measure and clarifications as to which performance measures are intended to be captured by the staff notice. The revised staff notice is expected to be released in the near future so that entities who are preparing their annual financial statement for the 2015 calendar year end will have it available.

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

UPDATE ON PREVIOUS ITEMS DISCUSSED BY THE GROUP

IAS 23: Financial Liabilities Measured at Fair Value through Profit or Loss

At its June 2014 meeting, the Group recommended that this issue be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee. The AcSB staff reported that the AcSB discussed the issue at its September 2015 meeting and observed that while the

issue highlights a potential improvement to the requirements in IAS 23 *Borrowing Costs*, there does not appear to be widespread diversity among Canadian entities. The AcSB decided no further action should be taken because this issue would not meet the IFRS Interpretations Committee's agenda criteria.

IAS 21: Determining Functional Currency

At its September 2015 meeting, the Group recommended that this issue be discussed with the AcSB to determine whether it should be referred to the IASB or IFRS Interpretations Committee. The AcSB staff reported that the AcSB discussed the issue at its November 2015 meeting and directed the staff to undertake further limited research on the issue to find out whether there is diversity in practice, particularly among Canadian development-stage entities.

OTHER MATTERS

Draft IFRIC Interpretations

In October 2015, the IASB's IFRS Interpretations Committee issued two Draft Interpretations:

- Foreign Currency Transactions and Advance Consideration – to provide guidance about which exchange rate should be used to report foreign currency transactions when payment is made or received in advance; and
- Uncertainty over Income Tax Treatments – to provide guidance when there is uncertainty in the application of tax law.

Canadian stakeholders were encouraged to submit their comments on both proposals to the IFRS Interpretations Committee before the comment period deadline.

IAS 16 and IAS 38: Variable Payments for Asset Purchases

The IFRS Interpretations Committee received a request to address the accounting for variable payments to be made for the purchase of an item of property, plant and equipment or an intangible asset outside of a business combination. The issue was discussed at the Committee's November 2015 meeting and the Committee concluded that it could not reach a consensus on whether the variable payments that depend on a purchaser's future activity should be recognized as a liability until that activity is performed and what the initial measurement of this liability should be. The Committee observed that the issue is too broad to address within the confines of existing IFRSs and decided not to add this issue to its agenda. This issue is related to a topic that was discussed by the Group in its September 2014 (refer to "IFRS 3, IAS 16 and IAS 37: Contingent Consideration in an Asset Purchase"). Stakeholders are encouraged to follow the status of the issue.

IAS 36: Recoverable Amount and Carrying Amount of a Cash-generating Unit

The IFRS Interpretations Committee received a request to clarify the application of paragraph 78 of IAS 36 *Impairment of Assets*. This paragraph sets out the guidance for considering recognized liabilities for determining the recoverable amount of a cash-generating unit within the context of an impairment test for a cash-generating unit. The issue was discussed at the Committee's November meeting but was not added to the Committee's agenda in light of the existing IFRS requirements. The

Group had discussed a similar issue regarding the application of paragraph 78 of IAS 36 (refer to "IAS 36: Recoverable Amount"). Stakeholders were encouraged to write to the IFRS Interpretations Committee before the end of the comment period if they have any concerns with the tentative agenda decision and follow the status of the issue.

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