2019 Financial Reporting Developments - IFRS

November 2019

Overview

- **IFRS Interpretation Committee (IFRIC)**
  - A interpretative body of the International Accounting Standards Board, which responds to questions about the application of the IFRS Standards
  - Issues authoritative Interpretations of IFRS standards
  - Issues agenda decisions which explain the requirements of IFRS, and are persuasive and should be considered
- **IFRS Discussion Group (IDG)**
  - A discussion forum to assist the Accounting Standards Board regarding the identification of issues arising on the application of IFRSs in Canada and to raise awareness in Canada of IFRS matters arising in practice
  - IDG meeting reports do not constitute official pronouncements or authoritative guidance, but do provide helpful insights on topical Canadian IFRS practice issues

IFRS Interpretation Committee [IFRIC]

Costs to fulfill a contract [IFRS 15]

- **Issue:** Can the following costs in constructing the good be recognized as costs incurred to fulfil a contract under IFRS 15?
- **Fact pattern:**
  - Company C transfers control of a good over time, and therefore, satisfies a performance obligation and recognizes revenue over time, and measures progress towards completed satisfaction of the performance obligation using an output method in accordance with IFRS 15.
  - Company C also incurs costs in constructing the good.
  - At the reporting date, the costs incurred relate to construction work performed on the good that is transferring to the customer as the good is being constructed.
- **Question:**
  - Can Company C capitalize those costs as costs to fulfil the contract under IFRS 15?

Costs to fulfill a contract [IFRS 15] (cont'd)

- **Conclusion:** No
- **Highlights:**
  - IFRS 15.39 states that the objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer.
  - In considering the recognition of costs, IFRS 15.98[c] requires an entity to recognize as expenses when the incurred costs relate to satisfied performance obligations [or partially satisfied performance obligations] in a contract — i.e. costs that relate to past performance.
  - In this case, the costs of constructing the good relate to partially satisfied performance obligations and should be expensed

IFRS Discussion Group [IDG]

Timing of implementation of IFRIC agenda decisions

IFRIC agenda decisions reflects and explains existing requirements of IFRSs

[1] If a company applied an IFRS Standard in a manner that is inconsistent with an agenda decision, does it necessarily have a prior period error?

- Not necessarily. Agenda decisions often provide new information that should be seen as helpful and persuasive in improving financial reporting.

[2] How soon does a company have to implement a final agenda decision?

- In the March 2019 IFRIC update, it was noted that IASB "expects that an entity would be entitled to sufficient_time to make that determination and implement any change"

[3] What does sufficient time mean?

- IASB expects an entity to implement it as soon as possible [on a timely basis]
- IASB has suggested that this would not extend beyond a matter of months, not years
- Prepares, auditors, and regulators will need to apply judgment depending on complexity of implementation based on facts and circumstances
- Disclosure considerations if agenda decision has yet to be implemented

IDG topic highlights
IFRS 15 and IAS 10: Realization of variable consideration

- **Background:**
  - IFRS 15 requires:
    - An entity to consider variable consideration and constrain the estimates of variable consideration when determining the transaction price
    - Include variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved
    - An entity to update its estimate of variable consideration to represent faithfully the changes in circumstances present during or at the end of the reporting period
  - Per IAS 10, events that occur after the reporting period and before the date when the financial statements are authorized for issue can either be:
    - Those that provide evidence of conditions that existed at the end of the reporting period [adjusting events after the reporting period]; or
    - Those that are indicative of conditions that arose after the reporting period [non-adjusting events after the reporting period].
  - An entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting period.

IFRS 15 and IAS 10: Realization of variable consideration (cont'd)

- **Fact Pattern:**
  - Company E enters into a contract with Customer Z on November 30, 2018 to deliver 100 widgets on December 31, 2018 [which is when the performance obligation is satisfied].
  - The transaction price is $1,000 per widget and there are no other performance obligations in the contract. Company E has a 30-day return policy. Payment is due on January 31, 2019.
  - Historical returns have been 3-5% of total widget sales for each respective month. Company A has constrained the transaction price to $95K, applying estimated returns of 5%.
  - Company E has a December year end and financial statements will be authorized for issue on March 31, 2019.
  - Customer Z returned 2 widgets [or 2%] on January 30, 2019.

IFRS 15 and IAS 10: Realization of variable consideration (cont’d)

- **Question 1:** Is variable consideration that is resolved after the reporting period considered an adjusting event under IAS 10 Events after the Reporting Period ?

  [1] Return of 2 widgets is an adjusting event

  [2] Return of 2 widgets is not an adjusting event.

- **Conclusion:**
  - Most members supported “No”, but was not unanimous
  - To consider expectation of whether a significant reversal would take place based on facts and circumstances as at the reporting date
  - To consider whether the entity’s process to estimate variable consideration as at year end was adequate. In this fact pattern, the entity’s process was considered to be rigorous.
  - Absent any abnormal changes in the market or the entity’s products, the estimates made by entity at year end do not need to be adjusted if the entity’s estimation process was adequate.

Amendments to IFRS 3

Definition of a business

IFRS 3: Definition of a Business
Background and transitional provisions

- Refresher on IFRS 3

Accounting topic	Business combination	Asset acquisition
Transaction costs	Expensed	Capitalized
Goodwill or bargain purchase gain	Only arises in a business combination	Not recognized
Measurement of assets acquired and liabilities assumed	Generally at fair value	Generally at relative fair value
Measurement period	Up to one year from acquisition date, if certain criteria are met	No measurement period
Deferred taxes	Generally, recognized	Generally, not recognized
Consideration is in shares	IFRS 2, Share-Based Payment ("IFRS 2") does not apply	IFRS 2, applies
Contingent consideration	IFRS 3 provides clear guidance	IAS 16, Property, Plant and Equipment and IAS 38, Intangible Assets have no clear guidance
Disclosures	More onerous	Less onerous

IFRS 3: Definition of a Business
Background and transitional provisions (cont'd)

- In October 2018, the International Accounting Standards Board [IASB] issued narrow-scope amendments to IFRS 3, particularly the definition of a business
  - Purpose: to assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition
- These amendments are expected to bring more consistency with the equivalent amendments made to US GAAP in 2017 [Accounting Standards Update No. 2017-01, *Clarifying the Definition of a Business]*
- The amendments are effective for annual reporting periods beginning on or after 1 January 2020 and are to be applied prospectively
  - Earlier application is permitted and must be disclosed

- **Expected impact:**
  - On transition: minimal
  - However, entities should update their accounting policies in a timely manner for future acquisitions

IFRS 3: Definition of a Business
Optional concentration test

Test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets

Gross assets used in this test exclude:

- Cash and cash equivalents
- Deferred tax assets
- Goodwill resulting from the effects of deferred tax liabilities

When assessing whether assets are similar, entities shall consider the nature of each single identifiable asset and the risk characteristics [i.e. risks associated with managing and creating outputs from the assets]

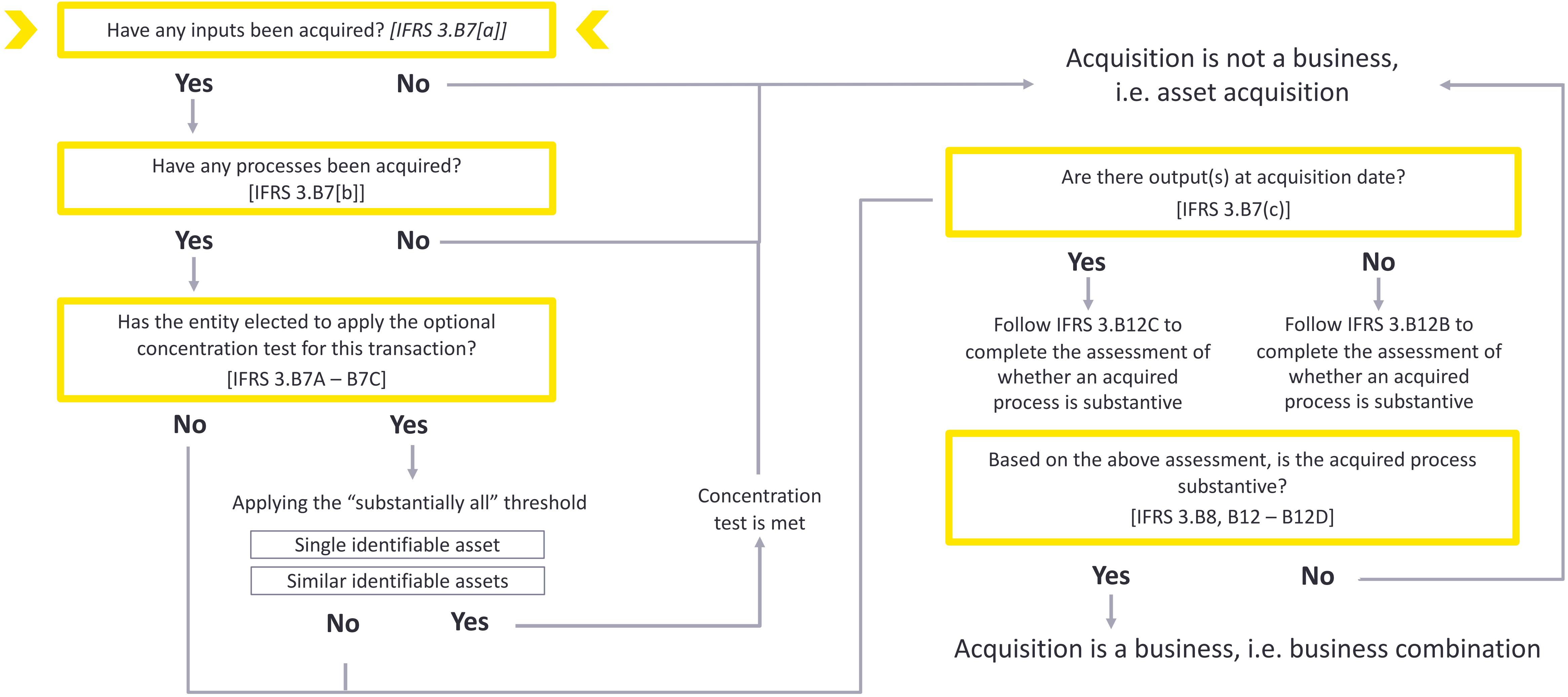
The following shall not be considered similar assets:

- a tangible asset and an intangible asset
- tangible assets in different classes unless considered a single identifiable asset based on specific criteria
- identifiable intangible assets in different classes
- financial assets in different classes
- a financial asset and a non-financial asset
- identifiable assets that are within the same class of asset but have significantly different risk characteristics

Elect to apply this test on a transaction-by transaction basis

IFRS 3: Definition of a Business

Summary – decision tree



IFRS 3:Definition of a Business
Transition considerations

- **Issue:** How can the amendments to IFRS 3 be early adopted by entities?
- **Fact pattern:**
  - Entity A made 3 acquisitions during 2018 [on 1 February, 1 November and 1 December] and would like to early adopt the amendments to IFRS 3 in fiscal 2018
  - Prior to the amendments to IFRS 3, these acquisitions would be accounted for as business combinations
  - If the transactions are assessed under the amended definition of a business, all acquisitions would be accounted for as asset acquisitions
  - Year-end: 31 December
- **Conclusion:**
  - IDG members supported applying the amended definition of a business to all three acquisitions if the amendments were early adopted regardless of whether there was interim reporting requirements or not

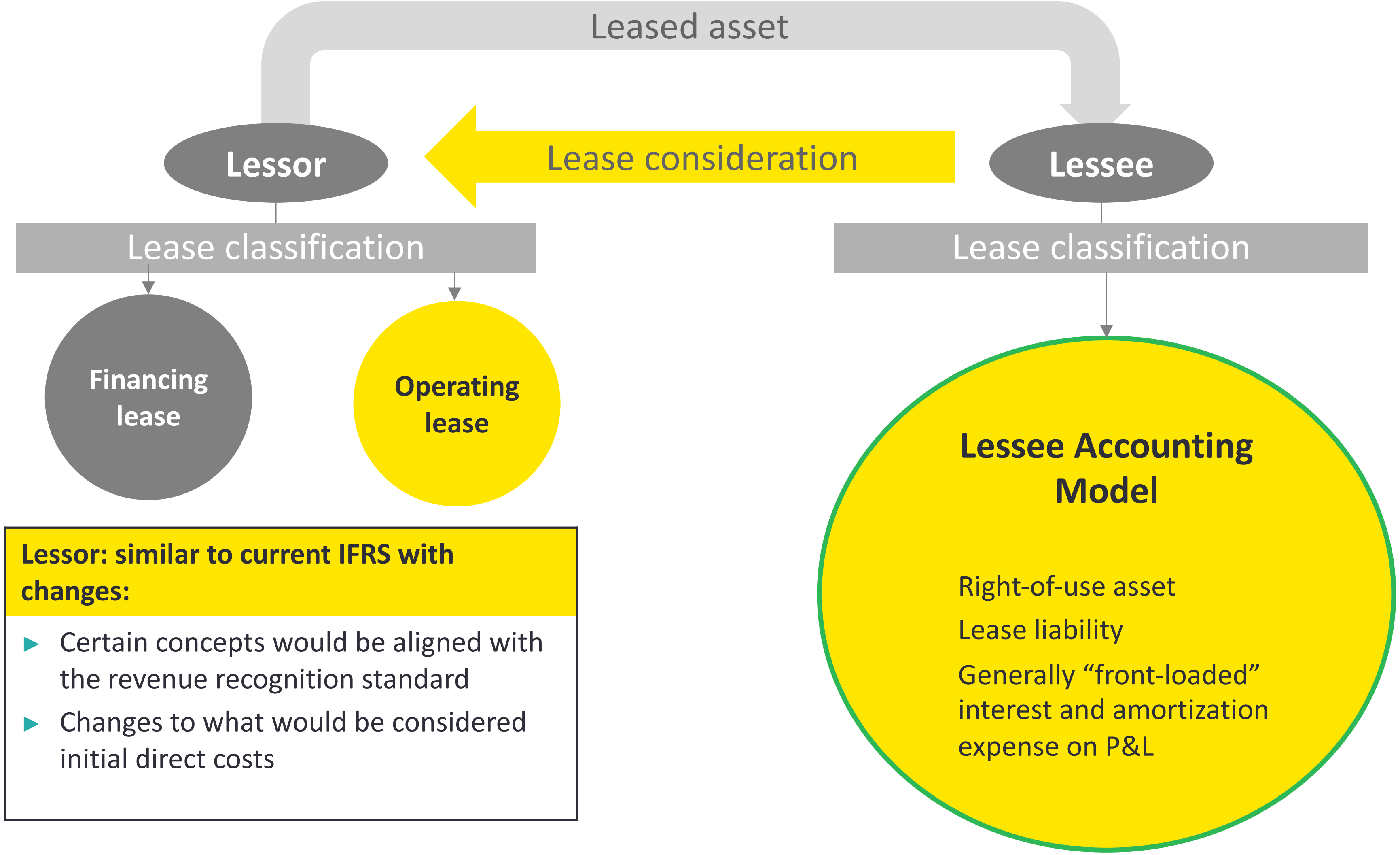
IFRS 16 – Leases

Overview

- IFRS 16 Leases was issued in January 2016
- Lessees will have a single on balance sheet accounting model for all leases, with exemptions for leases of 'low-value assets' and short-term leases
- Lessor accounting is substantially unchanged
- Lessees and lessors will have additional disclosure requirements compared to current accounting
- The IASB and the FASB made different decisions about lease classification and the recognition, measurement and presentation of leases for lessees and lessors

New standard will be effective for annual periods beginning on or after 1 January 2019

IFRS 16 - Lease Classification
Unchanged for Lessor and Single Class for Lessee



IFRS 16 Leases
Scope and Definition of a Lease

- A contract is, or contains, a lease if:
  - There is an identified asset (explicit or implicit)
  - The contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration – i.e., throughout the period of use the customer would have the right to:
    - Direct the use of the identified asset (i.e., direct how and for what purpose the asset is used) **and**
    - Obtain substantially all of the economic benefits from directing its use
  - The supplier does not have a **substantive** substitution right

IFRS 16 Leases
Separating Components of a Lease

- Lease and non-lease components are accounted for separately
  - Each lease component – apply IFRS 16
  - Each non-lease component – apply other standards

- Practical expedient:
  - Lessees can make a policy election (by underlying asset class) to account for lease and non-lease components as lease components

- Allocate consideration to lease and non-lease components:
  - Lessees – on a relative stand-alone price basis (unless the practical expedient is elected)
  - Lessors – using the new revenue recognition standard (i.e., IFRS 15 *Revenue from Contracts with Customers*)

IFRS 16 Leases
Lessee Accounting – Recognition and Measurement

Initial recognition and measurement	► Initially measure right-of-use (ROU) asset[1] and lease liability at present value of lease payments
Subsequent measurement of lease liability	► Accrete the lease liability based on the interest method using a discount rate determined at lease commencement[2] ► Reduce lease liability by payments made
Subsequent measurement of ROU asset	► Depreciate ROU asset, based on IAS 16 *Property, Plant and Equipment* ► Alternative measurement of ROU asset under IAS 16 and IAS 40 *Investment Property*
Profit and loss	► Generally 'front-loaded' expense for individual lease ► Separate interest and depreciation

1 Initial measurement of the ROU asset would also include the lessee's initial direct costs; prepayments made to the lessor, less any lease incentives received from the lessor; and restoration, removal and dismantling costs.

2 As long as a reassessment and a change in the discount rate have not occurred.

Practical Considerations
What makes transition to the new leases standard complex?

The new leases standard would continue to require significant judgments and estimates. However, many of these judgments and estimates may receive scrutiny because of the financial statement impact and additional disclosures.

Input from:

- Financial/accounting
- Treasury
- Corporate real estate
- Business operations
- Legal
- IT
- Tax

Judgments/estimates of:

- Is it a lease?
- Are there non-lease components in the contract?
- What is the lease term considering renewal, termination and purchase options?
- Are there variable lease payments and residual value guarantees?
- What is the lease classification?
- What is the discount rate?
- Does the transaction qualify for sale-leaseback accounting?
- How do you evaluate lessee involvement in asset construction?

Determination of:

- Lease-related assets and liabilities
- Subsequent measurement

Is the necessary level of cross-functional support in place for the project?

IFRS 16 – Leases [Recent updates]

IFRS 16 – Summary of recent updates

IFRIC updates

Topic	Date
Subsurface rights	Mar 2019
Customer’s right to receive access to the supplier’s software hosted on the cloud	Mar 2019
Liabilities in relation to a joint operator’s interest in a joint operation	Mar 2019
Lease term and useful life of leasehold improvements [tentative decision]	Jun 2019
Incremental borrowing rate [tentative decision]	Jun 2019

IFRS 16 – Summary of recent updates

IDG updates

Topic	Date
Accounting for asset retirement obligations	Oct 2019
Identifying separate lease components	Oct 2018
Guidance on “low-value” leases	Oct 2018
Identifying the Customer in a Lease Contract for the Use of Assets by a Joint Arrangement [IFRS 11 and 16]	Oct 2018
Lessee’s Discount Rate [IFRS 16]	Oct 2018
Disclosing the Effects of Adopting the Leases Standard [IFRS 16 and IAS 34]	Jan 2019
Scope exemption for non-regenerative resources	Jan 2019
Determining lease payments	Jun 2019
Right of first refusal	Jun 2019

Accounting for asset retirement obligations

- **Fact pattern:**
  - On January 1, 2020, Entity A entered into a 10 year lease for land that qualifies as a lease under IFRS 16.
  - The lessee installs equipment, that it owns, on the land and constructs a concrete base to support and attach the equipment to the land [i.e. effectively immoveable].
  - The lease agreement states that the lessee is required to remove the equipment and restore the land back to its original condition at the end of the lease term. [The lessee determines that a liability for restoration should be recognized under IAS 37.]

- **Question 1: How should the lessee account for these costs?**

  [1] Account for the costs as part of the right-of-use asset.

  [2] Account for the costs as part of the item of PPE

Accounting for asset retirement obligations (cont'd)

- **Conclusion:**
  - IDG members presented mixed views
  - The issue was ultimately brought to the IASB staff, who clarified that the accounting of such costs depends on whether they are incurred in relation to the leased or owned asset.
    - In the fact pattern, the obligation to dismantle and restore the land arose from the installation and concrete attachment of the equipment to the land.
    - As such, based on the IASB staff's clarification, these costs were incurred in relation to the owned asset and as such the related ARO should be accounted for as part of the item of PPE and not the ROU asset.

EY

Right of first refusal

- **Fact pattern:**
  - Company A enters into a 10-year contract with Company B for 70% of the capacity of a specific gas pipeline. The pricing of the contract is at market terms.
  - Company A also has a right of first refusal [ROFR] over the remaining 30% of the capacity of the pipeline, such that Company B can only sell additional capacity to other customers if Company A agrees not to purchase the remaining capacity.
  - Assume there are other potential customers in the vicinity that could use the additional capacity.
- **Question:** Does the fact that Company A has a right to obtain the additional available capacity through a ROFR give Company A the right to substantially all of the economic benefits of the asset, or should the assessment be based on the likelihood that Company A will use the additional capacity?

[A] The legal right to take the additional capacity before it is offered to others gives the customer the right to substantially all of the capacity of the pipeline

[B] Evaluate the ROFR based on facts and circumstances considering whether Company A intends to use the additional capacity

Right of first refusal (cont'd)

- **Conclusion:**
  - IDG members expressed mixed views
  - Several group members supported View A, because they found that in the particular fact pattern presented the ROFR gave Company A the right to substantially all of the economic benefits from use of the pipeline throughout the period of use.
    - However, these group members acknowledged that in the oil and gas industry, the terms and conditions of arrangements with a ROFR clause are complex and can differ widely.
  - Another member, who supported view B, explained that many factors beyond pricing, can make the ROFR non-substantive and unlikely to be exercised.
  - Some Group members discussed whether Company A's intention to exercise its rights should be factored in deciding whether the ROFR is substantive.
  - Given the diversity and potential impact on the oil and gas industry, the group recommended this issue be discussed at the AcSB's July 2019 meeting.

Incremental Borrowing Rate (Tentative Agenda Decision)

- **Question:** Is a lessee's incremental borrowing rate [IBR] required to reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments?

- **Tentative conclusion:**
  - The committee observed that:
    - The lessee's IBR is a lease-specific rate that is to take into account the terms and conditions of the lease, and that
    - The definition of a lessee's IBR requires a lessee to determine its IBR for a particular lease considering the terms and conditions of the lease, and determine a rate that reflects the rate it would have to pay to borrow '*over a similar term*', [along with other factors not discussed on this slide].
  - The committee explained that the definition of a lessee's IBR does not explicitly require a lessee to determine its IBR to reflect the interest rate in a loan with a similar payment profile to the lease payments, however, in applying judgement in determining its IBR, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.

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