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Project **New items for consideration**

Topic **IAS 39 *Financial Instruments: Recognition and Measurement*—Derecognition of financial assets**

Introduction

1. This paper deals with question D as identified by the staff in the cover paper.

The issue

2. The issue in question D split into two subquestions:

   (a) **Question A**—What is the accounting treatment if the bonds described in the fact pattern are not derecognised? Should they be accounted for in accordance with paragraph AG62 or alternatively accounted for in accordance with paragraph AG8? and

   (b) **Question B**—If the bonds are not derecognised, should they be reclassified from loans and receivables if the market for the new bonds is active?

Views identified in the submission

Question A

3. The submitter identified two alternative views:

4. Proponents of **<u>View 1</u>** argue that paragraph AG62 of IAS 39 would apply. This states that a modification of a liability has no profit or loss impact and the effect is dealt with through a modification of the effective interest rate and no profit or loss impact is accounted for.

5. Proponents of **<u>View 2</u>** argue that paragraph AG8 of IAS 39 would apply. Hence, the carrying amount of the asset is recalculated by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92 of IAS 39. The adjustment is recognised in profit or loss.

6. Proponents of these two views argue that whether View 1 or View 2 would apply depends upon whether paragraph 17(b) of IAS 39 or paragraph 40 of IAS 39 has been applied to analyse the effect of the modification of contractual terms.

Question B

7. Proponents of the two alternative views identified above also argue that in the case in which the former bonds were classified as loans and receivables, and the exchange is considered to be a modification (and therefore no derecognition is required), there is the question whether the bonds can continue to be classified as loans and receivables if the market for the new bonds is active. In their view, the standard is silent, leaving some to argue that the bonds can still be loans and receivables, even if there is an active market.

Staff analysis

Question A

8. The staff note that both views expressed in this question of the submission assume that there is a modification of a financial asset that does not result in derecognition of the financial asset.

9. IAS 39 provides explicit guidance on this point. IAS 39.AG84 sets out the accounting for modifications of cash flows when a financial asset is not derecognised. This paragraph clearly states that when a financial asset is modified as a result of the financial difficulties of the issuer the effect of the modification is reflected in the impairment of the asset using the original effective interest rate.

10. In the view of the staff, as IAS 39 provides explicit guidance for this fact pattern neither of the views expressed by the submitter for Question A can be applied if it were concluded that the GGBs subject of the Bond Exchange were not derecognised. If the original bonds were not derecognised (which issue is analysed further in agenda paper 10A) the modified cash flows must be discounted at the original effective interest rate to measure the impairment of the bonds in accordance with IAS 39.AG84.

Question B

11. This question deals with the issue of whether reclassification out of loans and receivables is required or permitted if the new bonds are not derecognised and the market becomes active.

12. The staff note that the general principle in IAS 39 is that classification occurs upon initial recognition. A financial asset can be reclassified if and only if the financial asset meets the criteria for reclassification set out in paragraphs 50 to 54 of IAS 39. The staff are of the view that if a bond is modified but not derecognised, the reclassification requirements in IAS 39 continue to apply in the same way. IAS 39 includes specific guidance on when reclassification shall

occur. Reclassification is not applicable for financial assets that are classified as loans and receivables.

13. The staff emphasise that the above analysis assumes that the modification has not resulted in derecognition of the original financial asset. This issue is further analysed in agenda paper 10A for the fact pattern being considered. It is noted that if the original asset was derecognised as a result of the Bond Exchange fact pattern, a new asset is recognised. In that case, the new financial asset must be classified on initial recognition (refer to paragraphs 9 and 14 of IAS 39).

Questions for the Committee
1. Does the Committee agree that in this fact pattern, neither paragraph AG62 nor AG8 would apply as a consequence of the derecognition of the old bonds in accordance with paragraph 17(a) of IAS 39 as IAS 39 sets out explicit guidance for the treatment of a financial asset that is modified but not derecognised in AG84? 2. Does the Committee agree that the new asset should be subject to the classification criteria like any newly recognised financial asset? 3. Does the Committee agree that if the Bond is not derecognised the reclassification requirements in IAS 39 would apply? 4. Does the Committee agree that in relation to questions A and B, the requirements in IAS 39 are clear and therefore there is no interpretative issue to be addressed? 5. 5. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1 The staff propose the following wording for the tentative agenda decision:

IAS 39 *Financial Instruments: Recognition and Measurement*—Derecognition of financial instruments upon modification

The Interpretations Committee (the Committee) received a request for guidance on the circumstances in which the restructuring of Greek government bonds (GGB) should result in derecognition of the whole asset, or only part of it, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. In particular the Committee has been asked to consider whether either paragraphs AG8 or AG 62 of IAS 39 would be applicable to the fact pattern submitted if the GGBs were not derecognised.

The Committee observed that if a financial asset is modified because of the financial difficulty of the obligor but not derecognised that IAS 39 sets out (in AG84) the requirements for the accounting for the modification. Neither IAS 39.AG8 nor IAS 39.AG62 are applicable.

In addition, the Committee was asked whether reclassification out of loans and receivables is required or permitted if the new bonds are not derecognised and the market becomes active.

The Committee observed that if a financial asset is modified but not derecognised the reclassification requirements in IAS 39 apply as for all other financial assets. However, it also noted that if a modification of the contractual terms results in the derecognition of the original financial asset and the recognition of a new financial asset, IAS 39 would clearly require that new financial asset to be classified on its initial recognition.

Consequently, the Interpretations Committee [decided] not to add the issue to its agenda.