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Project **New items for consideration**

Topic **IAS 39 *Financial Instruments: Recognition and Measurement*—Classification of a security with payments linked to the Gross Domestic Product of the issuer**

Introduction

1. This paper deals with Question F as identified by the staff in the cover paper.

The issue

2. The issue in Question 6 relates to how to account for the GDP-linked securities granted as part of the restructuring transaction described in the cover paper. [The terms and conditions of the GDP-linked securities are attached as Appendix C to this paper]

Views identified in the submission

3. The submitter noted that IAS 39 refers to a 'non-financial variable that is not specific to a party to the contract' but does not define the meaning of that term. Under the assumption that the GDP link is a non-financial variable specific to the issuer, the submitter identifies four alternatives to account for the GDP-linked securities issued as part of the restructuring agreement:

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(a) **Alternative 1**: the instrument is 'close' to being a derivative and should be accounted for at fair value through profit or loss;

(b) **Alternative 2**: the instrument should be accounted for at amortised cost and paragraph AG8 of IAS 39 should be applied to account for the modification of cash flows;

(c) **Alternative 3**: the instrument is classified as available for sale; or

(d) **Alternative 4**: the instrument is not within the scope of IAS 39 and the entity should apply IAS 18 *Revenue* to recognise the revenues from the instrument and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to account for a provision if needed.

Staff analysis

Is the issuer's GDP a non-financial variable specific to a party to the contract?

4. The staff note that the first question is whether the security's indexation to the issuer's GDP gives rise to an underlying that is a non-financial variable specific to a party to the contract:

   (a) if so, the security would have to be classified as a non-derivative financial asset into the appropriate of the four categories of financial assets of IAS 39.

   (b) if not, the security would meet the definition of a derivative and classification as at fair value through profit or loss would be mandatory.

5. The staff note that the question of what constitutes an underlying that is a non-financial variable specific to a party to the contract was on several previous occasions considered by the IFRIC and the International Accounting Standards Board (IASB). Information on those previous deliberations is included in Appendix B.

Staff conclusion

6. The staff consider that the issue of whether an underlying is a non-financial variable specific to a party to the contract fails the agenda criteria. Given the previous unsuccessful attempts of the IFRIC and the IASB to address the issue the staff conclude that:

   (a) *The issue can**not** be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

   (b) *It is **not** probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

What is the accounting for the GDP-linked security if it does not meet the definition of a derivative?

Ramifications of the assumption in the submission

7. In the previous section the staff concluded that the decision of whether the GDP-linked security meets the definition of a derivative does not meet the agenda criteria. This means that it would remain an open question whether it is appropriate that the submission assumes[1] that the GDP-linked security is not a derivative.

8. However, in the staff's view the four alternatives that the submitter identified on the basis of that assumption can be narrowed down. Hence, the staff consider that even though diversity in practice could not be eliminated it could still be significantly reduced. Therefore, the staff analyse the four alternatives[2] that the submitter identified. The alternatives are analysed in the order 4, 1, 2 and 3.

[1] See paragraph 3.
[2] See paragraph 3.

Alternative 4—Instrument is not in the scope of IAS 39

9. The GDP-linked security entitles the holder to payments only if for a reference year both:

   (a) the nominal GDP exceeds a threshold amount; *and*

   (b) the real GDP growth rate exceeds a threshold rate.

10. The two types of thresholds are specified for the relevant years covered by the life of the contract.

11. For a reference year for which those conditions are fulfilled, the payment to the holder is determined by multiplying the real GDP growth rate less the threshold rate by the notional amount of the GDP-security (subject to a leverage factor and a cap). The GDP-linked security also includes a written call option that allows the issuer to buy it at a strike price that depends on the security's average market price over a specified period before the date on which notice of the option's exercise is given.

12. The staff consider that the GDP-security is a structured option that entitles the holder to cash payments depending on the development of different aspects of the underlyings of the nominal and the real GDP of the issuer. This structured option is a contractual right to receive cash contingent on the development of the issuer's GDP. Hence, this option meets the definition of a financial instrument.[3]

13. The staff further consider that this financial instrument does not meet any of the scope exceptions of IAS 39. Hence, the staff dismiss Alternative 4.[4]

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[3] Even if a payout under a contract is not an absolute right but contingent on the occurrence of a future event it still meets the definition of a financial instrument (see IAS 32.AG8).

[4] The staff note that the scope of IAS 18 also includes revenue arising on financial instruments and from providing financial services. However, IAS 18 refers to IAS 39 for interest type revenue (dividend type revenue and financial services type revenue do not apply for the issue analysed in this paper). Hence, applying IAS 18 and IAS 39 is in this case not mutually exclusive (as Alternative 4 implies).

Alternative 1—the instrument is close to a derivative and should hence be classified as at fair value through profit or loss

14. The staff note that the decision whether the instrument meets the definition of a derivative relates to the assumption in the submission (see paragraph 7). The staff consider that once the assumption is made that the GDP-linked security does not meet the definition of a derivative, the fact that it might be viewed as 'close' to that definition does not mean it can be treated as if it were one. Mandatory classification as at fair value through profit or loss by definition only[5] applies if the financial instrument is a derivative[6].

15. Hence, the staff dismiss Alternative 1.

Alternative 2—amortised cost

16. A financial asset is measured at amortised cost in accordance with IAS 39 if it is classified as:

    (a) loans and receivables; or

    (b) held to maturity.

17. The staff note that the definition of loans and receivables excludes those financial assets [emphasis added]:[7]

    > for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, <u>which shall be classified as available for sale</u>.

18. The staff note that the GDP-linked securities were granted as part of the consideration for the bonds surrendered in the exchange. The fair value of the GDP-linked securities on initial recognition in accordance with IAS 39.43 is the initial investment in the asset.

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[5] Notwithstanding the other conditions that could result in classification as held for trading (ie acquired principally for the purpose of selling or being part of a portfolio with a recent actual pattern of short-term profit-taking).

[6] The exceptions (ie financial guarantee contracts or a designated and effective hedging instrument do not apply in this case).

[7] See IAS 39.9, definition of loans and receivables, item (c).

19. As noted in paragraph 9, any payment to the holders of the GDP-linked security depends on exceeding the thresholds related to the issuer's GDP. Hence, the holder may not recover its initial investment because of the development of the issuer's GDP. The staff do not consider that the failure to reach those thresholds could be construed to be 'credit deterioration'.[8] The staff note that notion of credit deterioration relates to the *collectibility* of cash flows. This is also reflected in paragraph AG85 of IAS 39, which links the notion of credit deterioration to estimating impairment. Hence, the staff are of the view that the GDP-linked security does not meet the definition of loans and receivables.

20. The staff consider that the fact that the holder may not recover its initial investment because of the development of the issuer's GDP also prevents classification of the GDP-linked securities as held to maturity. The definition of held-to-maturity investments requires that an entity has the positive intention and ability to hold that financial asset to maturity. The application guidance in IAS 39 further clarifies the notion of positive intention to hold to maturity for financial assets that are callable by the issuer:[9]

> The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.

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[8] The nominal GDP threshold amount is set at increasing amounts over the years and the real GDP threshold rate is set as a positive rate of at or above 2 per cent over the years.
[9] See IAS 39.AG18.

21. The issuer call option embedded in the GDP-linked security (see paragraph 11) can result in a strike price that means the holder would not recover substantially all of its carrying amount (which is amortised cost). [10]

22. The staff also note that this result is consistent with the rationale that precludes classification as loans and receivables, which is set out in IAS 39.BC29:

> [However, the Board was concerned that removing this requirement might result in some instruments that should be measured at fair value meeting the definition of loans and receivables and thus being measured at amortised cost.] In particular, the Board was concerned that this would be the case for a debt instrument in which the purchaser may not recover its investment, for example a fixed rate interest-only strip created in a securitisation and subject to prepayment risk. The Board therefore decided to exclude from the definition of loans and receivables instruments for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration. Such assets are accounted for as available for sale or at fair value through profit or loss.

23. This makes it clear that for financial assets that involve the possibility of not recovering the amortised cost carrying amount, the IASB considered measurement at amortised cost inappropriate. Instead, the IASB decided that one of the two categories that use fair value measurement should be required.

24. Hence, the staff dismiss Alternative 2.

Alternative 3—available for sale

25. The staff note that as a result of its analysis regarding Alternatives 4, 1 and 2 the GDP-linked securities would be classified as available for sale unless one of the

[10] IAS 39.AG18 refers to *would* not result in recovering substantially all of its carrying amount. But that paragraph also in the earlier sentence says that the criteria for a held-to-maturity investment with an issuer call option is met if the holder would recover substantially all of its carrying amount because that simply accelerated the asset's maturity. Hence, if the issuer call option *could* result in the holder not recovering substantially all of its carrying amount that would also preclude classification as held to maturity.

classification criteria for at fair value through profit or loss other than meeting the definition of a derivative apply.[11]

Staff recommendation

26. The staff recommend that the Interpretations Committee should not add this issue to its agenda because:

    (a) The agenda criteria are not met regarding the issue of whether an underlying is a non-financial variable specific to a party to the contract (see paragraph 6).

    (b) Once the assumption is made that the financial instrument is not a derivative the classification criteria of IAS 39 result in classification as either available for sale or at fair value through profit or loss. The staff also note that if the Committee considered that changes to IAS 39 were required that IFRS 9 already eliminates ie the categories loans and receivables and held to maturity. The issue also relates to a current IASB project (the limited review of classification and measurement under IFRS 9).

[11] That means if an entity designates a GDP-linked security under the fair value option or if the other conditions that could result in classification as held for trading apply (ie acquired principally for the purpose of selling or being part of a portfolio with a recent actual pattern of short-term profit-taking).

Questions for the Committee
1. Does the Committee agree that the question whether the security's indexation to the issuer's GDP gives rise to an underlying that is a non-financial variable specific to a party to the contract is a question that does *not* meet the agenda criteria? 2. Does the Committee agree that the GDP-linked security in the fact pattern submitted meets the definition of a financial asset but none of the scope exception of IAS 39 and should therefore be accounted for in accordance with that standard? 3. Does the Committee agree that the GDP-linked security neither meets the definition of loans and receivables nor of financial assets held to maturity and therefore cannot be accounted for at amortised cost? 4. Does the Committee agree that the GDP-linked security in the fact pattern submitted would be accounted for as a financial asset available for sale (unless one of the classification criteria for classification as at fair value through profit or loss applies)? (This assumes that the definition of a derivative is not met—whether that assumption is correct relates to Question 1, which in the staff's view does not meet the agenda criteria. Hence, this assumption is taken as a given and the answer to Question 4 does not imply agreement or disagreement with that assumption.) 5. Does the Committee have any comments on the proposed wording of 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 appropriate accounting for the GDP-linked security that was offered as part of the restructuring of Greek government bonds (GGB).

The submitter noted that IAS 39 refers to a 'non-financial variable that is not specific to a party to the contract' but does not define the meaning of that term. The Committee discussed whether the security's indexation to the issuer's GDP gives rise to an underlying that is a non-financial variable specific to a party to the contract.

The Committee concluded that this issue fails its agenda criteria because:

(a) The issue cannot be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.

(b) It is not probable that the Committee will be able to reach a consensus on the issue on a timely basis.

However, the Committee noted that the four alternatives in the submitted fact pattern were based on the assumption that the indexation to the issuer's GDP is a non-financial variable specific to a party to the contract. The Committee considered that because of its conclusion on the first issue it would remain an open question whether that assumption is appropriate. However, the Committee also thought that it could still narrow down the four alternatives that the submitter identified on the basis of that assumption. This would not eliminate but significantly reduce diversity in practice.

Firstly, the Committee discussed whether the GDP-linked security is within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. The Committee noted that that the GDP linked security is a structured option that entitles the holder to cash payments depending on the development of different aspects of the underlyings of the nominal and the real GDP of the issuer. This structured option is a contractual right to receive cash contingent on the issuer's GDP exceeding particular thresholds. Hence, this option meets the definition of a financial instrument. The Committee also considered that

this financial instrument does not meet any of the scope exceptions of IAS 39. Hence, the Committee concluded that the GDP-linked security is within the scope of IAS 39.

Secondly, the Committee considered that the assumption in the submission meant that the GDP-linked security does not meet the definition of a derivative. Once that assumption is made, the fact that the GDP-linked security might be viewed as 'close' to the definition of a derivative does not mean it can be treated as if it were one. Mandatory classification as at fair value through profit or loss by definition only applies if the financial instrument *is* a derivative.

Thirdly, the Committee discussed whether the GDP-linked security would meet the definition of a financial asset measured at amortised cost. The Committee noted that a financial asset is classified as amortised cost in accordance with IAS 39 if it is classified as:

(a) loans and receivables; or

(b) held to maturity.

The Committee observed that the definition of loans and receivables excludes those financial assets "for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale".

The Committee noted that in the submitted fact pattern, the GDP-linked securities were granted as part of the consideration for the bonds surrendered in the exchange. This means that the fair value of the GDP-linked securities on initial recognition in accordance with IAS 39.43 is the initial investment in the asset. The Committee noted that the any payment to the holders of the GDP-linked securities depends on exceeding the thresholds related to the issuer's GDP. Therefore, the holder may not recover its initial investment because of the development of the issuer's GDP. The Committee considered that the failure to reach those thresholds could not be construed to be 'credit deterioration'. Hence, the Committee concluded that classification as loans or receivables would be inappropriate.

Further on this issue, the Committee discussed whether classification of the GDP-linked security as a financial asset held to maturity would be appropriate. The Committee observed that the definition of held-to-maturity investments requires that an entity has the positive intention and ability to hold that financial asset to maturity. In addition, the application guidance in IAS 39 clarifies that the criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover

substantially all of its carrying amount. The Committee noted that the GDP-linked security has an embedded issuer call option that could result in a strike price at which the holder would not recover substantially all of the carrying amount of the financial asset (which is amortised cost). Therefore the Committee concluded that classification as held to maturity would be inappropriate.

Lastly, as a result of its analysis of the submitted fact pattern the Committee concluded that the GDP-linked securities would be classified as available for sale unless one of the classification criteria for at fair value through profit or loss (other than meeting the definition of a derivative, which was excluded by the submitter's assumption) applied.

The Committee considered that no clarification of IAS 39 was required. Even if changes were required, the Committee considered that IFRS 9 already eliminated the categories loans and receivables and held to maturity. The Committee further noted that the issue also relates to a current IASB project (the limited review of classification and measurement under IFRS 9). Consequently, the Committee [decided] not to add the issue to its agenda.

Appendix B—Previous Deliberations

Tentative IFRIC agenda decision in July 2006

B1. A submitter asked the IFRIC whether contracts indexed to an entity's own EBITDA or own revenue meet the definition of a derivative. At its meeting in July 2006, the IFRIC considered two different aspects:

(a) *First*, the IFRIC considered whether the reference to non-financial variables that are specific to a party to the contract was restricted to insurance contracts. The IFRIC did not believe that IAS 39 included that restriction. That meant that the question whether EBITDA or revenue are financial or non-financial variables was relevant (see (b) below). The IFRIC tentatively decided not to take this first issue on to its agenda because it did not expect significant diversity in practice to arise.

(b) *Second,* the IFRIC considered whether EBITDA or revenue were financial or non-financial variables and acknowledged that this was unclear from IAS 39. However, the IFRIC tentatively decided not to take this second issue on to its agenda because it believed it would be unable to reach a consensus on a timely basis.

IFRIC agenda decision in January 2007

B2. The IFRIC reconsidered the issue and at its January 2007 meeting decided to withdraw the tentative agenda decision. The IFRIC was concerned that taking no action would allow continued significant diversity in practice regarding how financial and non-financial variables were determined.

B3. Consequently, the issue was referred to the IASB with the recommendation to amend IAS 39 (possibly as part of the annual improvements process). That amendment should have limited to insurance contracts the exclusion from the definition of a derivative of contracts linked to non-financial variables that are specific to a party to the contract.

IASB Annual Improvements project 2007/2008

B4. As part of the Annual Improvements project in 2007/2008 the Board proposed amending IAS 39 as the IFRIC had recommended. However, the feedback was unsupportive12 and significant issues were raised in the comment letters. There was significant concern that the proposed amendment:

(a) would result in a significant change to current practice,

(b) would result in many different types of contracts meeting the (new) definition of a derivative and likely have unintended consequences;

(c) would require a separate project for a *major* amendment.

B5. To keep the project to its timetable, the Board at its February 2008 meeting decided to exclude this issue from the final annual improvements.

[12] Out of 61 respondents 33 did *not* support and 28 objected to the proposal.

Appendix C – Terms and Conditions of the GDP-linked Securities

C1 The staff has attached to this document an extract of the Invitation Memorandum by the Hellenic Republic dated 24 February 2012 that includes the terms and conditions of the GDP-linked securities. All information has been copied without modification.