Contact(s)	**Joao Santos**	jsantos@ifrs.org	+44 (0)20 7246 6410
Contact(s)	**Martin Friedhoff**	mfriedhoff@ifrs.org	+44 (0)20 7246 6410

Project	**New items for consideration**
Topic	**IAS 39 *Financial Instruments: Recognition and Measurement*—Derecognition of financial assets**

Introduction

1. In April 2012, the IFRS Interpretations Committee (the Committee) received a request for guidance on whether 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* (IAS 39). In particular, the Committee has been requested to consider whether the portion of the old GGBs that are to be exchanged for twenty new bonds with different maturities and interest rates should be derecognised. The specific fact pattern being considered is set out in paragraph 7.

2. The submitter requests the Committee to add this issue to its agenda because it has encountered different views regarding whether the portion of the exchange described in paragraph 7(b) below should result in derecognition, or alternatively be considered a modification that would not result in derecognition. An assessment of the Committee's agenda criteria can be found in paragraph 43 of this paper.

3. We asked IOSCO and a group of standard-setters in different countries to provide us with feedback on how widespread the level of holdings of Greek Government Bonds that will qualify for participation in the Private Sector Involvement is.

4. We asked IOSCO and the national standard-setters the following question:

    To what extent do entities in your jurisdiction have significant holdings of Greek Government Bonds that will qualify for participation in the Private Sector Involvement? –please also provide us with any further information that could help us assess this level of holdings.

5. Because we have set the deadline to receive comments on 11 May 2012, we will be providing the results of our outreach orally at the May 2012 Committee meeting.

Objective

6. The objective of this paper is to:

    (a) provide background information on the issue raised in the submission;

    (b) provide an analysis of the issue;

    (c) present an assessment of the issue against the Committee's agenda criteria;

    (d) make a recommendation to the Committee; and

    (e) ask the Committee whether they agree with the staff recommendation.

Issue raised

Main features identified

7. The submission describes a fact pattern in which the bondholders exchange their existing holdings of GGBs (irrespective of their maturity and terms and conditions) by surrendering them for new bonds to be issued by the same issuer. The transaction is structured as follows:

    (a) a percentage of the principal amount of the surrendered bonds is forgiven;

(b) a percentage of the principal amount of the surrendered bonds is exchanged for twenty new bonds, which bear interest at stepped fixed coupon rates with fixed maturities ranging from 11 to 30 years (the Bond Exchange);

(c) the remaining percentage of the surrendered bonds is exchanged for short-term securities guaranteed by a third party; and

(d) the bondholders also receive, together with each new bond, a security that entitles the holder to payments linked to the Gross Domestic Product of the issuer (but has no principal or interest payments).

8. The staff note that other aspects of the transaction are:

(a) paying accrued interest on the surrendered bonds (either by issuing accrued interest notes or as cash interest payments, depending on specifics of the bondholders);

(b) using the laws of England and Wales as the governing law for the new bonds (compared to Greek law for the surrendered bonds);

(c) introducing contractual collective action clauses for the new bonds;

(d) subjecting the new bonds to a co-financing agreement whereby if the debtor does not service any debt in full on a payment date the bondholders and other creditors (including the European Financial Stability Facility—EFSF) suffer a payment shortfall in the same proportion.

9. The submitter notes that only the views on the accounting for the exchange of the bonds referred to in subparagraph 7(b)—ie the Bond Exchange—have not achieved consensus and requests the Committee to analyse the possible outcomes and provide interpretative guidance on what the accounting treatment for this part of the transaction should be. This is because the submitter holds the view that there is general consensus that the other portions of the surrendered bonds mentioned above should be derecognised.

10. Hence, the summary of the submitter and staff's analysis in the sections below will only be focused on the part of the transaction that is the Bond Exchange.

Views and approaches included in the submission

11. The submitter identifies two possible approaches for dealing with this issue. These are:

    (a) **Approach A**—Even if IAS 39 does not make any specific reference to the 'exchange' of financial assets, the derecognition criteria specified under paragraphs 16 to 23 of IAS 39 are relevant and should be used in order to determine whether the old bonds should be derecognised.

    (b) **Approach B**—IAS 39 does not provide any specific guidance from a lender's perspective as to when derecognition applies to an exchange of debt instruments for new debt instruments of the same debtor that results in different contractual terms but is not considered to be an extinguishment for accounting purposes. Consequently, bondholders would have to develop an accounting policy by applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraphs 10 to 12. Paragraph 11 of IAS 8 requires that the first source of information to be used in making a judgement about the accounting policy to be applied is the requirements of IFRSs dealing with similar and related issues.

12. When analysing each of the approaches, the submitter identifies the following questions:

Approach A—Description of questions and alternative views in the submission

(a) **Question 1**—Does the Bond Exchange fall within the scope of IAS 39 paragraph 17(a)?

(b) **Question 2—**Does the Bond Exchange fall within the scope of IAS 39 paragraph 17(b)?

Question 1

13. The submitter identified two alternative views when analysing this question.

14. Proponents of **<u>View 1</u>** argue that derecognition is appropriate under paragraph 17(a) of IAS 39 because the cash flows of the original asset are not due any more and therefore they are considered expired. Hence, the original asset has to be derecognised.

15. Proponents of **<u>View 2</u>** argue that the cash flows on the old GGBs have not expired and that the new bonds are in fact a modification of the old bonds, which is not within the scope of paragraph 17(a) of IAS 39.

Question 2

16. The submitter identified two alternative views when analysing this question:

17. Proponents of **<u>View 1</u>** argue that the Bond Exchange does not fall within the scope of paragraph 17(b). This is because in the absence of a definition of a 'transfer', this notion is interpreted as implying a transfer to a third party. In the submitted fact pattern, the counterparty is the issuer of the bonds surrendered under the exchange, and so the transfer does not fall within the scope of paragraph 17(b) of IAS 39. Thus derecognition based on the criterion in paragraph 17(b) of IAS 39 does not apply.

18. Proponents of **<u>View 2</u>** argue that the Bond Exchange falls within the scope of paragraph 17(b) of IAS 39. This is because an exchange could be seen as a form of transfer in which the cash flows are transferred back to the issuer in exchange for the new bonds. Proponents of this view also argue that an analysis of the risks and rewards in accordance with paragraphs 20 to 23 of IAS 39 would then be necessary to determine whether derecognition is required.

Approach B—Description of questions and alternative views in the submission

19. The submitter also identified an alternative approach. Under this approach, it is considered that the Bond Exchange is not explicitly addressed by the

derecognition requirements of IAS 39 and therefore the bondholder will apply paragraphs 8 to 12 of IAS 8. IAS 8 requires management to use its judgement in developing and applying an accounting policy that results in information that is reliable and relevant to the needs of economic decision-making. The submitter identified two possible views in relation to this approach:

20. Proponents of **View 1** argue that an entity can choose to analogise to the financial liabilities derecognition criteria. They are of the view that in applying IAS 8, an entity may find paragraph 40 of IAS 39 a useful analogy. This paragraph states that an exchange between an existing borrower and an existing lender of debt instruments with **substantially different terms** shall be accounted for as an extinguishment of the original financial liability and the recognition of new liability. Paragraph AG62 provides further detail on the way in which this can be evaluated using a quantitative bright-line test of 10 per cent between the present value of the instrument before and after the changes in contractual cash flows.

21. Proponents of this view also argue that the outcome might differ based on facts and circumstances: ie it can be either derecognition or modification, on an instrument-by-instrument basis.

22. According to the submitter, critics of this view argue that derecognition rules are different for financial assets and financial liabilities, because impairment requirements exist for financial assets in order to reflect losses, while there is no equivalent for financial liabilities. Consequently, an analogy to financial liabilities should not be applied, because the principles, objectives and underlying ‘philosophies’ are different.

23. **View 2** argues that an entity should develop its accounting policy without analogising to financial liabilities (for the reasons given in paragraph 22) and instead look to other guidance, because IAS 39 does not explicitly address when this type of exchange results in derecognition. Hence, the entity would have to apply paragraphs 8 to 12 of IAS 8 and use its judgement in developing and

applying an accounting policy that results in information that is reliable and relevant to the needs of economic decision-making.

24. In developing an accounting policy IAS 8 requires that an entity considers (in descending order) the following sources:

    (a) requirements in IFRS dealing with similar and related issues; and

    (b) the Framework.

25. An entity *may* also consider the most recent pronouncements of another standard-setting body that uses a similar conceptual framework, accounting literature and accepted industry practices (*but only* to the extent those do not conflict with the IFRS related sources above).

26. The submitter noted that it has not carried out any further analysis of this view.

Staff analysis

27. The staff have responded to the issues raised by the submitter and described in the cover paper by examining the following questions in its analysis. *In all cases the analysis focuses only on the Bond Exchange ie the portion of the GGBs described in paragraph 7(b) of this paper*:

    (a) **Question A—**Does the modification to the GGBs result in expiry of the rights to the cash flows, which should therefore result in derecognition in accordance with paragraph 17(a) of IAS 39?

    (b) **Question B—**Is paragraph 17(b) applicable to this fact pattern?

    (c) **Question C—**Can the lender apply IAS 8 and analogise to the existing criteria for financial liabilities within the context of this fact pattern?

28. The questions are *analysed in the order B, A and C*.

Analysis of Question B

29. Question B deals with the issue of whether paragraph 17(b) of IAS 39 is relevant to the described fact pattern.

30. In the staff's view, the key issue is whether a 'transfer' can occur between the holder of a financial instrument and the obligor/issuer.

31. The term 'transfer' is not defined in IAS 39. However, the potentially relevant portion of paragraph 18 of IAS 39 (sub paragraph (a)) states that an entity transfers a financial asset if it transfers the contractual rights to receive the cash flows of the financial asset.[1] In the fact pattern submitted, the bonds are transferred back to *the issuer*._In the staff's view this is *not* a transfer as described in paragraph 17(b). By transferring the original GGB back *to the issuer* in effect the cash flow entitlement on the GGBs is extinguished. Put simply, the obligor cannot receive a right to payments from itself. As a result, the staff are of the view that for the purposes of paragraph 18, a holder is not able to transfer the right to receive cash flows to the obligor. Therefore:

    (a) Paragraph 17(b) only applies to transfers between a holder and a *third* party (ie an entity other than the issuer) and is not relevant to this fact pattern. As a consequence, paragraphs 19 to 23 of IAS 39 need not be considered.

    (b) Because giving the bonds back to the issuer is in effect an extinguishment, this transaction needs to be analysed under paragraph 17(a) instead of 17(b)—see the following section on Question A.

[1] The borrower does not have an obligation to pay anyone the original cash flows so IAS 39.18(b) is not analysed further.

Analysis of Question A

32. Paragraph 17(a) of IAS 39 states that an entity shall derecognise a financial asset, when and only when the contractual rights to the cash flows from the financial asset expire.

33. In the staff's view, a modification of the contractual terms of a financial asset *can* result in the expiry of the rights to the cash flows and hence derecognition of that asset in accordance with paragraph 17(a). However, the staff note that not all modifications of contractual terms will result in the expiry of the rights to the cash flows and hence derecognition of a financial asset. This is clearly reflected in the description of impairment accounting set out in paragraph AG84 of IAS 39.

34. Hence, it is necessary to assess whether a change in the contractual terms represents the expiry of the rights to the cash flows of the original instrument or merely changes to the continuing (original) instrument.

35. In the staff's view, the following aspects of the fact pattern are relevant for assessing the extent of change that results from the Bond Exchange:

    (a) A holder of a single bond has received in exchange twenty bonds with different maturities and cash flow profiles;

    (b) All of the bondholders received the same restructuring deal[2] irrespective of the terms and conditions of their individual holdings. This indicates that the individual instruments, terms and conditions were not taken into account. The different bonds (series) were not each modified in contemplation of their respective terms and conditions but instead replaced by a new uniform debt structure.

    (c) The terms and conditions of the new bonds are substantially different from those of the old bonds; this includes many different aspects such

[2] Except for paying accrued interest on the surrendered bonds—see paragraph 8(a).

as the change in governing law, the introduction of collective action clauses and the requirements of the co-financing agreement and modifications to the amount, term and coupons.

36. Those changes need to be assessed against the notion of ‘expiry’ of the rights to the cash flows in IAS 39.17(a).

Analysis of Question C

37. Question C relates to whether IAS 8 applies on the basis of the lack of specific guidance in IAS 39 for derecognition of financial assets as a result of the modification of the contractual terms and whether the guidance in paragraph 40 of IAS 39 for financial liabilities can be used by analogy for financial assets. Arguably this is applicable in IAS 39 because there is no explicit discussion of when a modification of a financial asset results in derecognition.

38. The staff note that IAS 8 requires that judgement[3] is applied to develop and apply an accounting policy in the absence of an IFRS that specifically applies to the transaction. IAS 8.11 requires that in determining an appropriate accounting policy consideration be given first to the requirements in IFRSs dealing with similar and related issues. This raises the question of whether it would be appropriate to analogise to the guidance in IAS 39 that addresses the derecognition of financial liabilities as a result of the modification of the contractual terms (paragraphs 40 and AG62 of IAS 39) and/or the general derecognition criteria for financial assets.

39. IAS 39.40 requires that a financial liability be treated as extinguished and a new financial liability recognised when there is a substantial modification of terms. Paragraph AG 62 and states that the terms are substantially different if the present value of the modified cash flows is at least 10 per cent different to the

[3] IAS 8 requires that the judgement be exercised in order to achieve information that meets the characteristics in IAS 8.10(a)-(b) and considers analogies to IFRSs and the Framework in accordance with IAS 8.11. Hence, this judgement is bound by those requirements and is not an absolute discretion.

present value of the cash flows prior to modification (using the original effective interest rate).

40. As noted above, it is clearly the case that some modifications of cash flows on financial assets do not result in derecognition. In particular, as set out in IAS 39.AG84 some modifications are accounted for in measuring the impairment of financial assets. It is clearly the case that because of impairment accounting, there are different considerations in accounting for the modification of cash flows on financial assets than for financial liabilities. In the view of the staff, while the principle of a 'substantial modification' may be useful in determining an appropriate policy for the derecognition of financial assets care needs to be taken with the test in AG62. Extending such a bright-line test to financial assets creates, in the staff's view a potential inconsistency, with the impairment guidance. This is because IAS 39 does envisage some modifications of cash flows that are accounted for as impairment of the original financial asset (for example, a deferral of the due dates of the original cash flows)[4] that can produce a difference in discounted present value that might be greater than 10 per cent. However, an analogy to IAS 39.AG62 would result in derecognition. In these scenarios, the correct accounting treatment is likely to be impairment. As a result, we are of the view that a direct analogy resulting in the consequent applicability of the *bright-line test* to financial assets is inappropriate.

41. However, when applying IAS 8, the staff consider that the notion of a *substantial* change of the terms of a financial liability that results in accounting for the change as an extinguishment is an appropriate analogy. IAS 39.40 sets out that such a change can be effected by the *exchange* of debt instruments or by way of *modification* of the terms of an existing instrument. Hence, using this analogy to financial liabilities, a substantial change of terms (whether effected

[4] See IAS 39.AG84 and IG E.4.3.

by exchange or by modification) would result in derecognition of the financial asset.

42. Whether the Bond Exchange is a substantial change of the terms of the financial asset needs to be assessed against the changes resulting from the transaction (see paragraph 35).

Agenda criteria assessment

43. The staff's <u>preliminary</u> assessment of the agenda criteria based on its knowledge and experience is as follows:

(a) *The issue is widespread and has practical relevance.*

No.

We understand that the concerns are specific to one transaction and the failure to reach consensus has not been widespread.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No.

We understand that most concluded that derecognition was appropriate. Therefore we do not expect significant divergence in practice.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

No.

Our view is that most of the respondents agree with View 1 of Question 1 in the submission, which is consistent with the staff's view. This being the case, all other questions become redundant.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Not applicable: We do not believe that there is a need for incorporating additional guidance to clarify the requirements in IAS 39 on derecognition of financial assets upon modification.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Not applicable. In our opinion, no formal interpretation is needed for this issue.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

Not applicable. We do not believe that the IASB should add this issue into its agenda.

Staff recommendation

44. On the basis of its analysis (in particular see paragraphs 35, 36 and 42 above), the staff consider that the changes resulting from the Bond Exchange transaction because of their type and effect give rise to an extent of change that:

(a) could be considered as representing the expiry of the rights to the cash flows of the original instrument; or

(b) is a *substantial* change of the terms of the financial asset by way of exchanging debt instruments.

Both alternatives result in the same accounting outcome: the derecognition of the surrendered bonds and the initial recognition of the new bonds as a different financial asset.

45. Assessing the Committee's criteria, the staff note that the issue is not prevalent and that there is not significant diversity in practice. Taking into account that the accounting outcome is the same under the views that the staff considered eligible, the staff do not recommend that the Committee should take this issue onto its agenda.

Questions for the Committee
1. Does the Committee agree that the changes arising from the transaction above give rise to an extent of change that could be considered as representing the expiry of the rights to the cash flows of the original instrument? 2. Does the Committee agree that applying IAS 8 and use the analogy in paragraphs 40 of IAS 39 (substantial change in terms) for financial liabilities would result in derecognition? 3. 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* (IAS 39). In particular, the Committee has been requested to consider whether the portion of the old GGBs that are exchanged for twenty new bonds with different maturities and interest rates should be derecognised or conversely accounted for as a modification or transfer that would not require derecognition. In addition the Committee has been asked to consider whether IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors (IAS 8)* would be applicable in analysing the submitted fact pattern.

The Committee observed that the term 'transfer' is not defined in IAS 39. However, the potentially relevant portion of paragraph 18 of IAS 39 states that an entity transfers a financial asset if it transfers the contractual rights to receive the cash flows of the financial asset. The Committee noted that paragraph 17(b) only applies to transfers between a holder and a third party (ie other than the issuer) and is not relevant to this fact pattern. In the fact pattern submitted, the bonds are transferred back to the issuer, which means that the transaction instead needs to be assessed against paragraph 17(a) of IAS 39.

The Committee noted that in order to determine whether the cash flow entitlement is extinguished it is necessary to assess the changes against the notion of 'expiry' of the rights to the cash flows in paragraph 17(a) of IAS 39. The Committee also observed that if an entity applies IAS 8 because of the absence in IAS 39 of an explicit discussion of when a modification of a financial asset results in derecognition, applying IAS 8 requires judgement to develop and apply an accounting policy. IAS 8.11 requires that in determining an appropriate accounting policy consideration be given first to the requirements in IFRSs dealing with similar and related issues. The Committee noted that in the fact pattern submitted, that requirement would lead to the development of an analogy to the notion of a substantial change (modification) of the terms of a financial liability in paragraph 40 of IAS 39.

If this notion is applied by analogy to assess whether the exchange of a portion of the old GGBs for twenty new bonds is a substantial change of the terms of the financial asset, the notion needs to be assessed against the changes resulting from the transaction.

In the fact pattern submitted, the relevant facts led the Committee to conclude that in determining whether the transaction results in the derecognition of the financial asset both approaches could be used to deal with the issue. The Committee noted however that derecognition is required under both approaches (ie extinguishment under paragraph 17(a) of IAS 39 or substantial modification of the terms of the asset).

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