IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 39—*Financial instruments: Recognition and Measurement*		
Paper topic	Holder's accounting for exchange of equity instruments		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. 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*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee received a submission from Organismo Italiano di Contabilità, the Italian national standard-setter, about the accounting by the holder of equity instruments in the circumstance in which the issuer exchanges its original equity instruments for new equity instruments in the same organisation but with different terms. Specifically, this transaction involved equity instruments issued by a central bank and the exchange of the instruments was imposed on the holders as a consequence of a change in legislation.

2. The accounting question asked is whether the holders of the equity instruments should account for this exchange under IAS 39 *Financial Instruments: Recognition and Measurement* as a derecognition of the original equity instruments and the recognition of new instruments.

3. This paper contains:

   (a) a summary of the submission, including the submitter's view;

   (b) an alternative view;

   (c) a summary of feedback received from outreach;

   (d) an agenda criteria assessment;

   (e) the staff recommendation; and

(f) a question to the Interpretations Committee to ask whether it agrees with the staff recommendation not to take the issue onto its agenda.

Submission

4. Below is a summary of the submitter's observations, based on the submission and our discussions with the submitter. The full submission is reproduced in Appendix C.

5. This summary covers:

   (a) the background to the issue;

   (b) the issues raised by the submitter; and

   (c) the view put forward in the submission.

Background to issue

6. The submitter notes that as a result of legislative changes and amendments to the central bank's by-laws, shareholders in the central bank were required to exchange all of their existing equity shareholdings (the Cancelled Shares) for new equity shares (the New Shares) also issued by the central bank. Consistently with the definition of equity shares in IAS 32 *Financial Instruments: Presentation,* dividends in respect of both shares are at the discretion of the issuer, within the limits set out in the terms of each class of share.

7. The submitter identifies the main differences between the New Shares and Cancelled Shares as follows:

   (a) Annual dividends on the Cancelled Shares were capped at a set proportion of reserves and could therefore increase over time as the reserves of the central bank grew. In contrast, annual dividends on the New Shares are restricted to net earnings for the year and are capped at an absolute amount.

   (b) On liquidation, the holders of the New Shares only have a right to receive an amount up to the share capital amount. Before the legislative

changes, it was unclear whether the holders of the Cancelled Shares had a residual claim on all the central bank's reserves on liquidation.

(c) The previous regulation required the approval of the central bank for the transfer of shares, while the New Shares are now freely transferrable within a wider (but still restricted) pool of potential shareholders. In addition, after a transition period, there is a ceiling on the percentage shareholding in New Shares by any entity or individual.

8. The submitter highlights that this transaction represents a 'unique case' that is not comparable with all other transactions related to an exchange of equity instruments issued by the same counterparty. This is because the central bank is a public interest entity whose governance and rights are established by specific legislation.

9. The shareholders in the central bank account for their investments in accordance with IAS 39.

Issue

10. The submitter is seeking guidance on whether shareholders in the central bank should derecognise their holdings in the Cancelled Shares and recognise the New Shares as a new financial asset under IAS 39. (Note that the derecognition requirements in IAS 39 are included in IFRS 9 *Financial Instruments* unchanged.)

11. The implication of this is whether, according to IAS 39, the investing entity would recognise a gain or loss in profit or loss on the exchange of equity instruments that are measured as available for sale or at cost under IAS 39 paragraph 46(c).

View of submitter

12. The submitter put forward one view, which is that the Cancelled Shares should be derecognised by the holder and the New Shares recognised as a separate asset.

13. Consistently with the conclusions of the IFRS Interpretations Committee in the *IFRIC Update* for September 2012 in relation to the restructuring of Greek Government Bonds, the submitter argues that:

(a) Because the Cancelled Shares are transferred back to the issuer rather than to a third party, the transaction should be assessed against paragraph 17(a) of IAS 39 (ie whether the contractual rights to the cash flows from the financial asset have expired).

(b) This assessment of the changes made by the share exchange should be carried out on a qualitative basis, because IAS 39 does not require a quantitative assessment for the derecognition of a financial asset in the case of an 'expiry' of the contractual rights to the cash flows from a financial asset (IAS 39 paragraph 17(a)). In addition, a quantitative test would be inappropriate for equity instruments, because of the lack of fixed contractual cash flows.

14. The submitter, having assessed the economic substance of the transaction, in particular that the risk/reward profile of the new instruments is substantially different from the risk/reward profile of the cancelled ones, concludes that the New Shares are different from the Cancelled Shares, both legally and economically, in terms of nature, economic rights and risk/reward profile. Hence, the exchange represents an expiry of the contractual rights to the cash flows from the Cancelled Shares.

Alternative view

15. An alternative view, not put forward by the submitter but described to the staff by another stakeholder, is that the Cancelled Shares should not be derecognised by the holder. Those who hold this view argue that the exchange of shares is not substantive and hence there has been no expiry of the central bank's shareholders' contractual rights to cash flows.

16. At this stage, IASB staff have not performed sufficient analysis to reach a staff view on the issue.

Outreach

Request for feedback

17. In order to gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard Setters and the IFRS technical teams of the international networks of large accounting firms. Specifically, we asked:

    (a) *Whether they are aware of similar transactions; that is, where a public interest/government-related entity whose constitution and governance are established by specific legislation:*

        (i) *has exchanged its equity financial instruments for different equity instruments issued by the same entity on substantially different terms and the exchange was not included in the terms of the original equity instruments (or has modified the terms of its equity instruments to achieve a similar effect); and*

        (ii) *has investors that account for their investment in the equity instruments in accordance with IAS 39 or IFRS 9.*

    (b) *What was the accounting treatment of each of the exchanges or modifications from the perspective of the investors under IAS 39 or IFRS 9 in respect of the example transactions identified? That is, did the investors in the issuing entity derecognise or continue to recognise their existing investment as a consequence of the transaction and what was the rationale for that accounting treatment.*

    (c) *To what extent do they observe diversity in the accounting treatment by the investor for such exchanges or modifications.*

18. The views received represent informal feedback and do not reflect the formal views of those organisations.

Summary of responses

19. We received 16 responses to our outreach request: 4 from large accounting firms; 10 from National Standard-Setters and 2 from regulators. By region, the responses from National Standard-Setters came from: North America 1; South America 1; Europe 3; Africa 1; and Asia-Oceania 4.

20. All respondents to our outreach request advised that either they were not aware of any other transactions similar to the specific one described in the submission or that such specific circumstances were rare.

Agenda criteria assessment

21. In this section, we assess the issues against the agenda criteria of the Interpretations Committee described in paragraphs 5.16–5.17 of the IFRS Foundation *Due Process Handbook*. Please refer to Appendix B of this Agenda Paper for the details of the agenda criteria and the assessment of the issue against the agenda criteria.

22. The assessment indicates that the agenda criteria are not met, primarily because:

    (a) outreach indicates that the fact pattern submitted is not common, if not indeed unique, and that the issue is not widespread; and

    (b) in respect of this particular transaction, no significant diversity in accounting was observed amongst the holders of the Cancelled Shares.

23. Furthermore, we note that the issue will be less relevant by 2018, which is the expected effective date of the final version of IFRS 9 *Financial Instruments*, which is due to be issued in 2014. This is because, unlike IAS 39, under IFRS 9 gains or losses on an equity financial asset are either recognised in profit or loss immediately or, if recognised in other comprehensive income, are *not* reclassified to profit or loss on derecognition the asset[1].

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[1] However, derecognition of the original equity financial asset under IFRS 9 does affect whether the holder can reconsider its election, on recognising a new equity financial asset, to take future fair value movements to other comprehensive income.

Staff recommendation

24. We recommend to the Interpretations Committee that it should not add this issue to its agenda, because the agenda criteria are not met.

Questions for the Interpretations Committee

Questions
1. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should not add this issue to its agenda? 2. If the answer to Question 1 is 'Yes', does the Interpretations Committee agree with the wording of the tentative agenda decision in Appendix A of this Agenda Paper?

Appendix A—Proposed wording for the tentative agenda decision

IAS 39 *Financial Instruments: Recognition and Measurement*—Holder's accounting for exchange of equity instruments

The IFRS Interpretations Committee (the Interpretations Committee) received a request about the accounting by the holder of equity instruments in the circumstance in which the issuer exchanges its original equity instruments for new equity instruments in the same entity but with different terms. Specifically, this transaction involved equity instruments issued by a central bank and the exchange of instruments was imposed on the holders as a consequence of a change in legislation.

The submitter asked whether the holders of the equity instruments should account for this exchange under IAS 39 *Financial Instruments: Recognition and Measurement* as a derecognition of the original equity instruments and the recognition of new instruments.

The Interpretations Committee observed that:

(a) because of the unique nature of the transaction, the issue is not widespread; and
(b) no significant diversity in accounting was observed amongst the holders of the equity instruments.

For these reasons, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Assessment against the Interpretations Committee's agenda criteria

B1. Below we have assessed the issue against the agenda criteria of the Interpretations Committee as described in paragraphs 5.14–5.22 of the IFRS Foundation *Due Process Handbook*.

Agenda criteria of the Interpretations Committee	
We should address issues (see paragraph 5.16 of the IFRS Foundation *Due Process Handbook*):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No. The issue is not widespread: outreach indicates that issue is specific to a limited number of holders of shares in the central bank and arises in one unique transaction, within one jurisdiction.**
in which financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No. There is no evidence of diversity in practice in respect of this transaction.**
that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*.	**No. The terms of this transaction are too specific to resolve efficiently.**
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS (see paragraph 5.17 of the IFRS Foundation *Due Process Handbook*)?	**No. We do not expect the issue to have broad applicability.**
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21 of the IFRS Foundation *Due Process Handbook*)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**No. Under final version of IFRS 9 to be issued in 2014 (expected to be effective from 2018), the implications of the issue will be less relevant.**

Appendix C—Submission

C1. We received the following request.

REQUEST FOR INTERPRETATION

1. Issue

1.1 Background: rationale for the reform and the transaction

A Decree-Law issued in 2013 provides for an increase to Euro 7.5 billion of the Central Bank's share capital (formerly Euro 156.000 as set by a previous Law) by converting a limited portion of statutory reserves into capital; the value of the shares has been estimated to be in a range between Euro 5 billion and 7.5 billion by a High Level Group of Experts in order to determine the share capital of the Central Bank. The same Decree-Law has as well resulted in a series of amendments to the Central Bank's bylaw, as better described below.

It is noted that the aim of the reform is motivated by the following reasons:

- in recent years the concentration of the banking industry has increased the percentage of the shares of the Central Bank held by the largest banking groups. No concrete problems have emerged, thanks to the limits to shareholders' rights, but it was necessary to avoid possible (wrong) perceptions that the Central Bank could be influenced by its largest shareholders;

- it was necessary to modify the previous rules governing the Central Bank's ownership structure (described below) in order to clarify that the shareholders have no economic rights over the portion of the Central Bank's reserves stemming from seigniorage, as the latter derives exclusively from the exercise of a public function (the issuance of currency) assigned by law to the central bank. The reform aimed at eliminating any ambiguity on this issue, clearly identifying the economic rights of the shareholders and aligning the rules governing the distribution of profits to those of other privately-owned central banks.

The key points of the reform are the following:

- Firstly, the list of entities potentially entitled to be shareholder of the Central Banks ([1]) has been revised and expanded by including additional categories of institutional investors such as pension funds.

[1] Before the above mentioned reform the shareholders of the Central Bank were mainly banks and insurance companies.

- Secondly, the transferability regime of the shares has been modified through the elimination of the acceptance clause of the Central Bank's governing body and the introduction of a ceiling on the stake that any individual shareholder may hold.

- Thirdly, the rules governing the distribution of profits to the shareholders have been modified by establishing a fixed ceiling on the amount of dividends, that is now linked to the amount of the share capital only, eliminating any economic right over the portion of the Bank's reserves (including returns for the period resulting from the investment of the same reserves) and explicitly limiting shareholders' rights in case of liquidation to the new value of the share capital (the nominal amount of Euro 7.5 billion). In order to achieve these goals it was necessary to estimate the current value of the existing Central Bank shares and to raise the (up to now merely symbolic) amount of the Central Bank's capital accordingly, by transferring part of the reserves to capital. The nominal amount of the new share capital has been established in such a way that the present value of future expected dividends after the reform is equal to the estimated current value of the shares of the Central Bank at the moment of the reform. Such equivalence was necessary in order to avoid that the reform could result in a "State Aid" or, alternatively, in a damage for the shareholders.

It should be noted that, in the absence of a clarification about the benefits the shareholders were entitled to (i.e. whether or not the shareholders had economic rights over the portion of the Central Bank's reserves stemming from seigniorage), a reliable fair value of the shares was assessed to be a difficult exercise before the issuance of the document prepared by the high level experts in early November 2013, as mentioned above, and of the draft Decree approved on November 30, 2013. As a result, many preparers had their shareholdings measured at cost in their Financial Statements according to IAS 39, paragraph 46 (c) ([2]). In addition, taking in to consideration: (i) the absence of a liquid market, (ii) the strict transferability regime for the shares and (iii) the valuation uncertainty caused by the unclear rules about the rights of the shareholders over the portion of the Central Bank's reserves, the banking supervisory authority set up a specific "prudential filter" for gains/losses resulting from any revaluation of the stake in the Central Bank. In addition, the initial cost of the shareholding was deducted from regulatory capital.

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[2] According to IAS 39 par. 46: "After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:
(a) [….]
(b) [….]
(c) investments in equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

1.2 Amendments to the bylaw

The reform pursued by the Decree has changed significantly the nature and the contents of the new shares, replacing the economic and governance rights, together with the transferability framework compared to the previous shares that have been canceled.

Following the Decree, the Central Bank has amended the bylaw and has, among other changes, executed a capital increase using existing statutory reserves. As a result, new financial instruments have been issued embedding the rights of the shareholders set down in the new bylaw (the "new shares"). The new shares have been attributed to shareholders replacing the previous ones (the "cancelled shares").

The reform of the Central Bank ownership has deeply modified the economic rights and the transferability framework of the shares. Furthermore the reform has also clarified which are the shareholders' rights in case of liquidation of the Central Bank.

In detail, with reference to the economic rights, the shareholders' rights in case of liquidation and the transferability, the new shares are different from the cancelled shares. In fact:

A. Economic rights

- **Economic rights limited solely to the earnings of the period**

  Before the reform, Central bank bylaw set the possibility to distribute to shareholders dividends from earnings of the period, limited to 10% of the share capital (the nominal amount of Euro 156,000); due to the symbolic value of the share capital, this amount was negligible. In addition, it was possible to distribute a dividend up to 4% of the reserves as reported in the previous period; such distribution would come from the returns for the period resulting from the investment of the same reserves. As a result, the returns of the cancelled shares were linked not only to the period earnings, but mainly to the returns of the investment of the reserves. This also implied that this additional amount coming from the returns of the investment of accumulated reserves was distributable also in case of a net profit for the period very low or nil. In fact, in some cases, the dividend distributed has been higher of the net profit.

  On the contrary, after the reform, the economic rights of the new shares have been limited solely to the dividends on net earnings, capped – by the Law - to 6% of the share capital (the nominal amount of Euro 7,5 billion). The regulation of the new shares, in fact, rules out any possible distribution to shareholdings coming from the return of the investment of the reserves. Thus, the shareholders have lost their pre-existing rights over the returns of the investment of the statutory reserves. Moreover, the undistributed profit will not contribute to the future growth of the remuneration of the shareholders.

- **Introduction of a maximum return of the shares that is stable over time**

  The previous regulation did not envisage absolute limits to the returns of the cancelled shares. Indeed, taking into consideration the dividends from the net profit but also the possibility to distribute the returns for the period resulting from the investment of the

reserves, the remuneration potentially attributable to the cancelled shares was increasing year after year and potentially without any limit.

The reform has limited the returns of the new shares solely to the dividend from the net profit with a maximum limit equal to 6% of the nominal amount of the share capital Accordingly, the reform has replaced a growing flow of dividends without any upper bound with a flow subject to a cap which is defined as a maximum amount stable over time.

B. Shareholders' rights in case of liquidation

Before the reform, in case of liquidation the shareholders' rights on accumulated reserves were unclear; after the reform, the shareholders are entitled to receive a maximum amount up to the shareholder capital (Euro 7.5 billion). On the other hand, in case of liquidation, the new shares will suffer losses only after the full depletion of the existing reserves at that time.

C. Different transferability framework of the shares

The new bylaw has amended the transferability rules of the new shares. In the current bylaw, in fact:

- the acceptance clause of the Central Bank's governing body in case of transfer of the shares has been eliminated;
- a maximum holding share of 3% (taking into account direct and indirect ownership) has been included;
- the regulation has defined that, with reference to current shareholders, no voting rights nor dividends will be entitled to shares exceeding this limit (dividends on excess shares will be allocated to statutory reserves), after a transitional period of 36 months (during the adjusting period the exceeding shares won't be entitled with voting rights but will still have rights to dividends);
- a different list of entities potentially entitled to own the new shares has been defined and, in particular, the categories of potential new shareholders have been broadened.

The changes to the transferability regime, as well as the broadened categories of possible entitled shareholders contribute to the development of a "market" for the new shares.

Main differences	Cancelled Shares	New Shares
Economic rights	The bulk of the remuneration of the cancelled shares was substantially linked to the **returns of the investment of the reserves** (potentially unlimited); only a negligible part of the remuneration was linked to the **net profit** of the period**.**	The economic rights of the new shares have been restricted **solely to the dividends on net earnings, capped to 6% of the share capital**. The regulation of the new shares, in fact, rules out any possible distribution to shareholdings coming from the returns of the investment of accumulated reserves.
	The previous regulation did not envisage absolute limits to the returns of the cancelled shares.	The reform has introduced a maximum limit to the distributable amount of dividends (€ 450 millions), that is **stable over time.**
Shareholders' rights in case of liquidation	Ambiguity in the old bylaws on whether the shareholders had a residual claim on all Central Bank reserves led to different interpretations by shareholders. The reform is aimed, among others, to remove this ambiguity.	In case of liquidation the shareholders are entitled to receive a maximum amount up to the shareholder capital (Euro 7.5 billion). On the other hand the new shares will suffer losses only after the full depletion of the existing reserves at that time.
Transferability of the shares	The previous regulation required the approval of the Central Bank for the transfer of shares, in view of the small number of parties able to take a stake in a bank's capital. Furthermore the previous regulation did not state a maximum holding limit.	According to the new regulation: • the approval of the Central Bank for the transfer of the new shares isn't required anymore; • a maximum holding share of 3% has been included; • the regulation has defined that no voting rights nor dividends will be entitled to shares exceeding this limit (dividends on excess shares will be allocated to statutory reserves), after an adjusting period of 36 months (during the adjusting period the exceeding shares won't be entitled with voting rights but will still have rights to dividends); • the categories of potential new shareholders have been broadened.

1.3 The accounting treatment of the transaction

IAS 39 "*Financial Instruments: Recognition and Measurement*" does not provide an explicit guidance on the accounting treatment, from the holder's perspective, of an exchange of a financial asset with another financial asset issued by the same counterparty.

Therefore, in application of par. 10 and 11 of IAS 8 "*Accounting Policies, Changes in Accounting Estimates and Errors*", the same considerations made by the IFRS IC in the September 2012 meeting related to the restructuring of Greek government bonds could be applied for the accounting treatment of the aforementioned transaction, even if the financial asset involved in the transaction is an equity instrument rather than a bond.

According to the IFRIC Update referred to the September 2012 meeting: "*The Interpretations Committee noted that, in the fact pattern submitted, the bonds are transferred back to the issuer rather than being transferred to a third party. Accordingly, the Interpretations Committee believed that the transaction should be assessed against paragraph 17(a) of IAS 39 ("An entity shall derecognise a financial asset when, and only when: (a) the contractual rights to the cash flows from the financial asset expire…."*).

In applying paragraph 17(a), the Interpretations Committee noted that, in order to determine whether the financial asset is extinguished, it is necessary to assess the changes made as part of the bond exchange against the notion of 'expiry' of the rights to the cash flows.

Therefore the transaction illustrated in paragraphs 1.1 and 1.2 has to be accounted against paragraph 17(a) of IAS 39.

According to IAS 39, par. 17, an entity shall derecognise a financial asset when, and only when:

(a) the contractual rights to the cash flows from the financial asset expire; or

(b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.

IAS 39 does not require a quantitative assessment for the derecognition of a financial asset in case of "expiry" (par. 17 a). A quantitative assessment is specifically required only in case of "transfer" of a financial asset by paragraph 20(a) ("*if the entity transfers substantially all the risks and rewards of ownership of the financial assets….)* and paragraph 21.

Therefore, the assessment of the expiry of the contractual rights to the cash flows from the financial asset according to IAS 39 par. 17 (a) shall be carried out only on a qualitative basis. To that end, it should be noted that the aforementioned transaction fully satisfies the qualitative requirements of IAS 39 par. 17 (a).

As explained in paragraphs 1.1 and 1.2, the reform pursued by the Decree Law 133/2013 has deeply changed the rights, the nature and, consequently, the risk-return profile of the new shares in comparison with the cancelled ones.

The peculiarity of the Issuer of the shares should also be taken into account: as a public interest entity whose governance and rights are imperatively established by law, the Central Bank is an "*unique*" case from the legal viewpoint, in that it does not fall into any predefined category with general and shared characteristics, due to the fact that its legal source and applicable provisions are issued *ad hoc*, i.e. they are specific and designed for that *individual* entity (the Central Bank). In short, the new shares issued by the Central Bank cannot be compared, for instances, to particular types of shares in joint-stock companies, namely shares to which "particular" rights are attached.

What has taken place with the reform is not a free of charge capital increase via assignment of new financial instruments. In the case of the Central Bank (a) the new financial instruments with different characteristics *supersede* the old ones (all shares are defined as being newly issued, not just those that ideally cover the capital increase); (b) there is a structural change in the type of instruments, which refers both to their core structure and essential features.

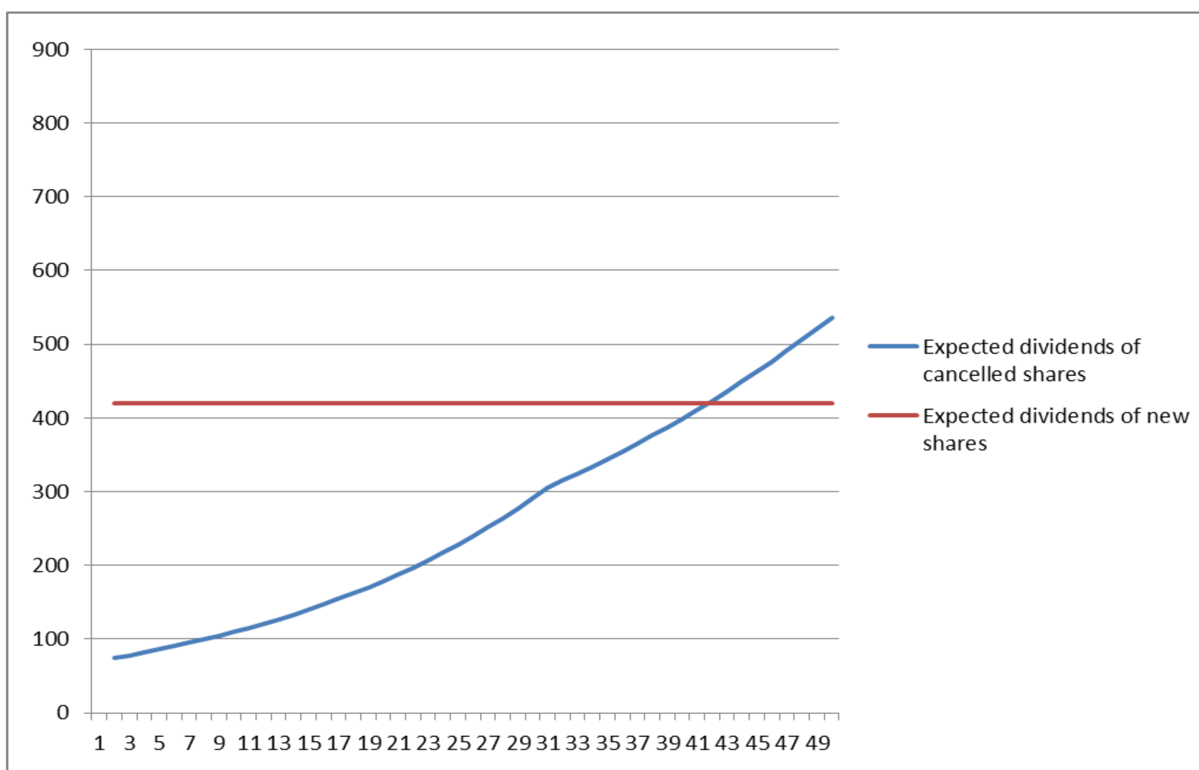
In conclusion:

- the aforementioned transaction represents a "unique case" and differs from all other transactions related to an exchange of equity instruments issued by the same counterparty;
- as a consequence of the reform introduced by the Decree, the new shares are deeply different in terms of nature, economic rights and risk profile as compared to the cancelled ones, even if at the date of the transaction the fair value of both instruments are bound to be the same.

These conclusions are confirmed by the assessment of the economic substance of the transaction, considering that the risk/reward profile of the new instruments is substantially different from the risk/reward profile of the cancelled shares, as better argued below.

In particular, the sensitivity of the value of the new shares to different market risk factors is significantly different from that of the cancelled ones. Consequently, the fair value of the cancelled shares and the fair value of the new shares, even if necessarily equivalent at the moment of the exchange, would have diverged in the future in most of the market conditions, because of the different profile and type of riskiness of the future cash-flows attributable to the shareholders before and after the reform.

In fact, under the regulation existing before the reform, the expected cash flows for the shareholders, almost exclusively from the returns of the investments of the reserves, would have grown in the future without any ceiling whereas the expected dividend of the new shares, exclusively from the net profit, will be initially higher and basically stable (supposing the existence of distributable profits) as reported in the chart below (amounts in €/millions) that illustrates the expected cash flows of the cancelled shares and of the new shares estimated by the High Level Group of Experts.



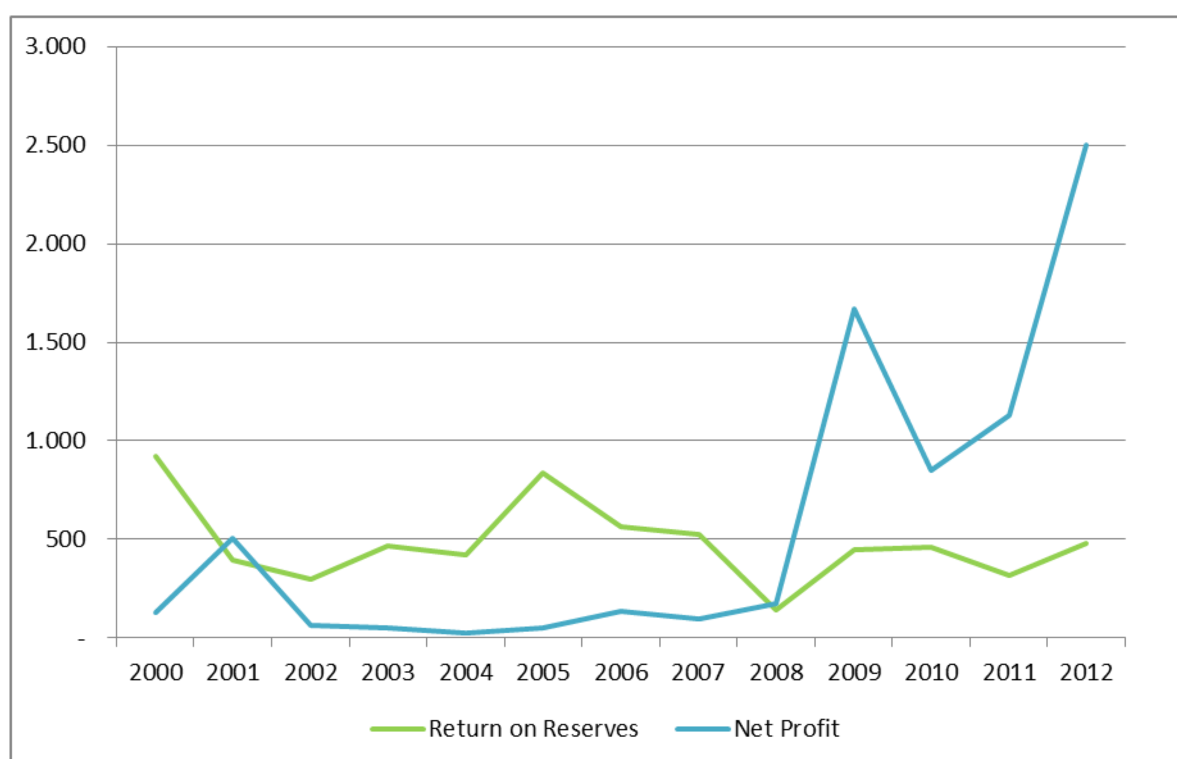
Moreover it is noted that the remuneration of the cancelled shares was insignificantly correlated from the profits of the Central Bank and the un-distributed profits contributed to the future growth of the remuneration of the shareholders whereas the new shares will be more interrelated with the profits of the Central Bank and any profit not distributed will be definitively lost for the shareholders.

In addition, before the reform the rights of the shareholders over the reserves in case of liquidation were not clear; under the new framework the Decree has clarified that the shareholders do not have any right on the reserves and then in case of liquidation the shareholders are entitled to receive a maximum amount up to the shareholder capital (Euro 7.5 million). On the other hand, in case of liquidation, the new shares will suffer losses only after the full depletion of the existing reserves at that time.

As a consequence, the risk/return profile of the new shares is significantly different from the one of the cancelled shares. In particular:

- the fair value of the new shares is more sensitive to a variation in the inflation risk, as for the new shares a maximum limit to the distributable amount of dividends, which is fixed in nominal amount, has been introduced;
- the fair value of the new shares is less sensitive to a variation in the real interest rate than the cancelled ones, given that the expected cash flows of the latter were mainly allocated in the long term; in practice the cancelled shares had a higher “real” duration than the new ones;

- while the distribution of the cancelled shares was insignificantly indexed to the earnings, a change in the expectation on volatility and profits of the Central Bank would affect in a more significant way the value of the new shares – whose remuneration is linked to the profits of the Central Bank – than the value of the cancelled shares – whose remuneration was mainly linked to the returns of the investment of the accumulated reserves (being the distribution of net earnings limited to a negligible amount). The graph below (amounts in €/millions) illustrates that in the previous 13 years there has been no significant correlation between the Central Bank's net profits (i.e. the parameter that is relevant for distribution for the new shares) and the return of the investment of accumulated reserves (i.e. the parameter that was relevant for distribution for the cancelled shares). The graph also shows that the volatility of the former (coefficient of variation equal to 131%) has been higher than the volatility of the latter (coefficient of variation equal to 41,3%);



- the reform has removed the conditions that implied, in substance, the immobilization of the cancelled shares, (removing the transfer pre-acceptance clause and setting a limit for the maximum shareholding); as a consequence, the sale is currently one of the possible scenarios for recovering the value.

Finally, in the IFRIC Update related to the restructuring of the Greek Bonds, *the Interpretations Committee also noted 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. Paragraph 11 of IAS 8 requires that, in determining an appropriate accounting policy,*

consideration must first be given to the requirements in IFRSs that deal with similar and related issues. The Interpretations 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 of the terms of a financial liability in paragraph 40 of IAS 39.

Paragraph 40 sets out that such a change can be effected by the exchange of debt instruments or by modification of the terms of an existing instrument. Hence, if this analogy to financial liabilities is applied to financial assets, a substantial change of terms (whether effected by exchange or by modification) would result in derecognition of the financial asset".

IAS 39 par. 40 clarifies when a substantial modification of the terms of a financial liability can be accounted for as an extinguishment: "*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*"".

According to IAS 39 AG 62 "*the terms are substantially different if the discounted present value of the cash flows under the new terms, […] is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.*"

As specifically noted by the IFRIC ([3]), it can be argued that the quantitative test required by IAS 39 AG 62 for the derecognition of a financial liability could be inappropriate for financial

[3] IFRIC *Staff paper* "IAS 39 *Financial Instruments: Recognition and measurement – Derecognition of financial assets*" issued in May 2012: *"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 present value of the cash flows prior to modification (using the original effective interest rate).*
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) 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. However, when applying IAS 8, the staff considers 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 by exchange or by modification) would result in derecognition of the financial asset. 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.*

assets: this is even more true for equity instruments, given the lack of fixed contractual cash flows and, consequently, the lack of an effective interest rate.

Therefore, with reference to the transaction illustrated in par 1.1 and 1.2, also in the context of IAS 39, paragraph 40, the *extinguishment* has to be assessed only on a qualitative basis considering the relevance of the modification of the economic rights associated to the shares. To this end, all the above considerations provided with reference to the application of IAS 39, par. 17 (a), are valid.

In conclusion, the proponent of this view believes that the Cancelled Shares should be derecognised and the New Shares have to be recognised. An adequate level of disclosure in the notes will be required.

REASONS FOR THE IFRS INTERPRETATION COMMITTEE TO ADDRESS THE ISSUE

a) Is the issue widespread and practical?

Generally, the issue on the sufficiency of the qualitative analysis against the applicability of IAS 39.17a), in case of equity instruments, could be considered widespread. With reference to the specific transaction described we highlight that the issue involves a large number of preparers (most of the Central Bank's shareholders apply IAS/IFRS), even if it is limited to a transaction that has happened only in one country.

b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

Although we do not have evidence of difference in practice, the issue is very recent and there is a possibility that different views arise.

c) Would financial reporting be improved through elimination of the diversity?

Currently there is not difference in practice since all the preparers holding the shares have accounted for the transaction as a derecognition of a financial asset.

d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and Framework for the Preparation and Presentation of Financial Statements, but no so narrow that is inefficient to apply the interpretation process?

The issue is sufficiently narrow to be capable of an interpretation by IFRIC.

e) If the issue relates to current or planned IASB project is there a pressing need for guidance sooner than would be expected from the IASB project?

Currently the project related to the derecognition of financial instruments is not in the agenda of the IASB. Furthermore the issue of the derecognition criteria is also discussed in the DP "A Review of the Conceptual Framework for Financial Reporting" issued in July 2013 which underlines that "the existing Conceptual Framework does not define derecognition and does not describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different Standards have adopted different approaches".

Angelo Casò

(Chairman)