STAFF PAPER

May 2016

IFRS Interpretations Committee Meeting

Project	New items for initial consideration
Paper topic	IAS 39 *Financial Instruments*: *Recognition and Measurement* / IFRS 9 *Financial Instruments*—Fees and costs included in the '10 per cent' test for the purpose of derecognition

CONTACT(S)	Mariela Isern	misern@ifrs.org	+44 (0)20 7246 6483
	Kumar Dasgupta	kdasgupta@ifrs.org	+44 (0)20 7246 6902

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request regarding IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*. The request asks the Interpretations Committee to clarify which fees and costs should be included in the '10 per cent' test for the purpose of derecognition of a financial liability.

2. The objective of this paper is to provide the Interpretations Committee with a summary of the issue and the staff's analysis and recommendation.

Structure of the paper

3. This paper is organised as follows:

   (a) Background;

   (b) Summary of outreach conducted;

   (c) Staff analysis;

   (d) Assessment against the Interpretations Committee's agenda criteria;

   (e) Staff recommendation;

(f) Questions for the Interpretations Committee;

(g) Appendix A—Proposed wording for tentative agenda decision; and

(h) Appendix B—Submission.

Background

The issue

4. The submitter has asked the Interpretations Committee to clarify which fees and costs should be included when applying the '10 per cent' test for the purpose of derecognition of a financial liability. According to paragraph 3.3.2 of IFRS 9, the Standard requires that:

> 3.3.2 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.

5. In addition, paragraph B3.3.6 of IFRS 9 states that [**emphasis added**]:[1]

> B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including **any fees paid net** of **any fees received** and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment,

[1] Paragraphs 40 and AG62 of IAS 39 were carried forward to IFRS 9 unchanged. These paragraphs of IAS 39 correspond to paragraphs 3.3.2 and B3.3.6 of IFRS 9.

> **any costs or fees incurred** are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, **any costs or fees** incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

6. The submitter states that there is an ambiguity as to what is meant by 'fees paid' in paragraph B3.3.6 of IFRS 9 with respect to applying the '10 per cent' test. The submitter has identified two views, from the point of view of the borrower.

View 1—only fees paid to, or received from, the lender

7. Proponents of this view think that fees included in the '10 per cent' test are limited to fees paid to, or received from, the lender. This is because, according to these proponents, the test is intended to capture cash flows between the borrower and the lender that may be referred to as a 'fee', but in substance are indistinguishable from the other contractual cash flows of the new debt. Hence, they should be included within the contractual cash flows of the new debt when determining whether the old and new debt are substantially different.

8. According to these proponents, the term 'costs' in paragraph B3.3.6 of IFRS 9 would include third-party costs or fees together with those costs or fees payable to the lender. Proponents of this view think that the lack of any reference to 'costs' in the sentence describing the '10 per cent' test in paragraph B3.3.6 of IFRS 9 reinforces the view that it is only fees paid to, or received from, the lender, not to other third parties, that are included in the '10 per cent' test.

9. In addition, proponents of this view note that the derecognition requirements in IAS 39 were based on the US GAAP requirements at the time the Standard was first issued. In particular, the requirements ASC 470-50-40-12 (a) state:

Modifications and Exchanges

> **40-12** The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10:

a. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification.

View 2—fees paid to, or received from, the lender plus directly attributable third-party fees

10. Proponents of this view think that the terms 'costs' and 'fees' in paragraph B3.3.6 can be read as synonymous. Consequently, these proponents think that no distinction should be made when performing the '10 per cent' test.

11. These proponents also draw an analogy to transaction costs included in the initial carrying amount of a financial asset or financial liability which includes, according to paragraph B5.4.8 'fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges and transfer taxes and duties.' For these proponents, it would not be consistent to define 'fees' narrowly for the purpose of the '10 per cent' test but more widely for the purpose of measuring financial assets and financial liabilities on initial recognition.

Summary of outreach conducted

12. 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 (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms (hereafter, 'accounting firms'). Specifically, we asked:
    (a) the most commonly observed approach that entities use in their consideration of the fees to include in the '10 per cent' test applying both IAS 39 and IFRS 9; and
    (b) the extent to which there is diversity in practice with respect to the issue submitted applying both IAS 39 and IFRS 9.

Responses received

13. We received 20 responses from the following respondents:

    (a) 1 group of regulators;

    (b) 14 national standard-setters; and

    (c) 5 accounting firms.

14. The views received represent informal opinions and do not reflect the formal views of those organisations.

15. The geographical breakdown for the responses received from national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	3
Europe	4
Americas	4
Middle East	1
Oceania	1
Africa	1
Total respondents	**14**

16. We summarise the results of the outreach in paragraphs 17–26.

Summary of outreach responses

17. The responses received revealed that View 1 is more commonly observed than View 2; however, the responses also reveal that there is diversity in practice. Some respondents observed, or thought that it is possible, that diversity in practice exists. Some other respondents stated that they have not observed diversity in practice in their jurisdictions; however, the approaches used vary across jurisdictions.

18. It is worth noting that some respondents think, however, that the inclusion of third-party fees is not a determinative factor in the outcome of the '10 per cent test'. This contrasts with the comments received from a European national standard-setter that thinks that the requirements in both IAS 39 and IFRS 9 are not sufficiently clear,

and that the approach taken in relation to the inclusion of third-party fees can affect the outcome of the '10 per cent' test.

19. The feedback received by type of respondent is summarised below.

Regulators

20. The regulator received responses from six different jurisdictions. The responses were based on IAS 39 as IFRS 9 is not yet widely applied. Of the responses received, two enforcers from major European markets noted that, in their jurisdictions, View 2 is the most commonly observed approach. These enforcers were not aware of diversity in practice in their jurisdictions. One of these enforcers recommended, however, clarifying the wording in paragraph B3.3.6 of IFRS 9, because it acknowledged that it can be ambiguous.

21. An enforcer from another major European market considered the issue to be a known area of diversity in the application of IAS 39, with his view being aligned to View 1. Another enforcer from another major European market observed that the requirements in paragraph B3.3.6 of IFRS 9 include the term 'fees' when referring to the '10 per cent' test; however, 'costs or fees incurred' are the terms used when dealing with the accounting for an extinguishment of a financial liability. In this enforcer's view, this highlights that there should be a different treatment for 'fees' and 'costs' when performing the '10 per cent' test. Nonetheless, however, this enforcer thinks that, from an economic perspective, third-party costs that are directly attributable to the modification of the terms of a financial liability should be included in the '10 per cent' test.

Accounting firms

22. The feedback received from all five accounting firms can be summarised as follows:

    (a) Two accounting firms stated that, according to their experience, it is uncommon for the inclusion or exclusion of third-party fees or costs to affect the outcome of the '10 per cent' test.

(b) Of the five accounting firms' comments, the following are the most relevant:

(i) in support of View 1, one accounting firm stated that the '10 per cent' test focusses on the significance of the change in the cash flows resulting from the changes in the contractual terms of the financial liability. In contrast, this accounting firm thinks that 'costs' incurred with third parties are not indicative of the significance of the change in the terms agreed between the borrower and the lender.

(ii) another accounting firm stated that its published guidance is also similar to View 1. However, for the purpose of the '10 per cent test', the firm's guidance also includes amounts paid by the borrower on behalf of the lender or by the lender on behalf of the borrower, in addition to fees paid to, or received from, the lender.

(iii) two accounting firms stated that, in their view, View 1 is consistent with the requirements in IAS 39 and IFRS 9; however, one of them stated that because the requirements are not clear either approach could be acceptable.

(iv) another accounting firm stated that they do not currently have any published guidance on the issue, which according to them reflects that it is uncommon for the issue to make a difference in practice.

(c) In relation to whether there is diversity in practice, the following are the most relevant comments:

(i) two accounting firms stated that the feedback received within their network confirmed that, only fees paid to, or received from, the lender (ie View 1) are included in the '10 per cent' test. One of these accounting firms is not aware of significant diversity in practice under IAS 39, nor of any reason why diversity should increase under IFRS 9. The other accounting firm thinks that on the basis of the feedback received, it is possible that there may be limited diversity in practice.

(ii) two accounting firms stated that they have observed or understand that there is diversity in practice. One of those firms also observed that because the requirements in IAS 39 are not clear and were carried forward to IFRS 9 unchanged, diversity in practice is expected to remain when entities apply IFRS 9.

(iii) one accounting firm stated that because in most cases the issue does not arise, it cannot confirm which view represents the most commonly observed approach in practice. In its view, the issue is not commonly observed because it is rare that both the '10 per cent' test is a dominant factor in the assessment of whether a financial liability has been substantially modified and the inclusion of third-party fees or costs affects the outcome of the '10 per cent' test.

National standard-setters

23. The majority of the national standard-setters stated that View 1 is the most commonly observed approach in their jurisdictions. The main comments received from some of these respondents are as follows:

(a) One European national standard-setter received answers from the banking sector that stated that in most instances the materiality of the costs incurred with third parties is relatively low. Consequently, only fees paid to, or received from, the lender, are taken into account in practice. Another European national standard-setter stated that the most commonly observed approach was View 1, and that it had not observed diversity in practice.

(b) One national standard-setter based in America stated that the majority of respondents of its jurisdiction did not anticipate that IFRS 9 would increase diversity in practice. Some of the respondents in that jurisdiction stated that View 1 was more appropriate, because only fees between the lender and borrower were included in the terms of a contract. Respondents in the financial services industry providing feedback to that national standard-setter noted, however, that they had observed diversity in practice, with some entities using the approach in View 2 for the purpose of the '10 per cent' test.

(c) The national standard-setter based in the Middle East noted that the most commonly observed approach in its jurisdiction (ie View 1) was consistent with US GAAP guidance and that it was not aware of diversity in practice.

(d) The national standard-setter based in Oceania stated that it had received a response only from a bank that indicated that, in practice, only fees between the lender and borrower are considered. Nonetheless, it thought that there could be diversity in practice and that further clarification was warranted. The national standard-setter based in Africa received feedback from an accounting firm. That accounting firm stated that the approach that it has most commonly observed is View 1, although they think that there is diversity in practice and that guidance would be useful.

24. Three national standard-setters stated that the most commonly observed approach in their jurisdictions was the approach represented by View 2. The main comments received from these respondents are as follows:

(a) Two national standard-setters based in the Americas stated that they had not observed diversity in practice in their jurisdictions. The main reasons that support the use of View 2 in their jurisdictions were as follows:

(i) all fees and costs incurred are considered when carrying out the '10 per cent' test, because those would not have been incurred if the financial liability had not been renegotiated; and

(ii) the approach in View 2 is aligned with the fees and costs considered within the transaction costs included in the initial carrying value of a financial asset or liability.

(b) A national standard-setter based in Asia stated that they had received feedback from three respondents noting that the most commonly observed approach was View 2. Two of those respondents had not observed any diversity in practice, whilst the third did not comment on this matter.

25. A European national standard-setter stated that the inclusion of third-party fees or costs when performing the '10 per cent test' may depend on individual facts and circumstances. This is because some fees or costs may or may not be closely interrelated with the cash flows of the new financial liability.

26. Another European national standard-setter considered that the requirements in IAS 39 and IFRS 9 are not sufficiently clear. It has observed diversity in practice, and is of the view that this is expected to continue when entities apply IFRS 9. This national standard-setter stated that it is aware that the outcome of the '10 per cent' test often directly depends on the approach taken (ie View 1 or View 2) and, thus, the lack of clarity creates structuring opportunities. This contrasts with comments from a national standard-setter based in Asia, which stated that in its jurisdiction the issue is not prominent. In many cases, it is obvious as to whether to derecognise financial liabilities as a result of modifications or exchanges without performing the '10 per cent' test. Consequently, this national standard-setter is of the view that, in many cases, the inclusion (or not) of fees to third parties in the '10 per cent' test is not determinative to the outcome of the test.

Staff analysis

27. The submitter is requesting clarity as to whether an entity includes fees and costs incurred on the modification or exchange of a financial liability that are paid to external third parties in the '10 per cent' test. For the purpose of analysing this issue, the staff have considered:

    (a) the relevance of third-party fees to the outcome of the '10 per cent' test on the basis of the outreach responses received (see paragraphs 28–30 of this paper); and

    (b) the requirements in IFRS 9 and IAS 39 to assess the appropriateness of the inclusion of third-party fees in the '10 per cent' test (see paragraphs 31–40 of this paper) .

Relevance of third-party fees to the outcome of the '10 per cent' test

28. For the purpose of analysing the issue submitted, the staff think that it is important to frame the relevance of the matter submitted within the context of the '10 per cent' test. In other words, how determinative is including, or not including, third-party fees to the outcome of the '10 per cent' test?

29. A number of outreach respondents (ie two accounting firms, entities in the banking sector submitting their feedback to a European national standard-setter and a national standard-setter based in Asia) were of the view that, in most cases, the inclusion of third-party fees would not affect the outcome of the test.

30. In fact, one accounting firm and the Asian national standard-setter did not even think that the '10 per cent' test itself was a dominant factor in the assessment of whether a financial liability had been substantially modified and, consequently, had to be derecognised. As mentioned in paragraph 26, this contrasts with one European standard-setter stating that its experience is that the outcome of the '10 per cent' test is often directly dependent on whether View 1 or View 2 is taken.

The requirements in IFRS 9 and IAS 39

31. The staff think that the definitions provided in Appendix A of IFRS 9 for the terms 'effective interest rate' and 'transaction costs' are relevant to the analysis of this issue. The staff note that the requirements in IFRS 9 that we have used in this section of the paper have been incorporated within IFRS 9, unchanged from IAS 39. Consequently, the analysis performed in this section is also valid when considering the requirements in IAS 39.

32. The definitions of 'effective interest rate' and 'transaction costs' are as follows [**emphasis added**]:

> Effective interest rate
>
> The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. […] **The**

> **calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), transaction costs, and all other premiums or discounts.** […].
>
> Transaction costs
>
> **Incremental costs** that are **directly attributable** to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

33. When considering the 'effective interest rate' definition, the staff note that the Standard distinguishes between **'fees and points paid or received between the parties to the contract'** and **'transactions costs'**. As per the definition above, 'transactions costs' are 'incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.'[2]

34. The staff think that this distinction between 'fees and points paid or received between the parties to the contract' and 'transaction costs' is useful for the purpose of analysing whether third-party fees should be included in the '10 per cent' test when applying paragraph B3.3.6 of IFRS 9. In particular, paragraph B3.3.6 of IFRS 9 states [**emphasis added**]:

> B3.3.6 For the purpose of paragraph 3.3.2, the terms are **substantially different** if the **discounted present value of the cash flows under the new terms**, including any fees paid net of any fees received and discounted using the original effective interest rate, **is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability**. If an exchange of debt

[2] We note that the sentence in bold in the definition of 'effective interest rate' in IFRS 9 in paragraph 32 of the paper was also included in the definition of 'effective interest method' in IAS 39. The definition of 'transaction costs' in IFRS 9 is identical to the definition of this term in IAS 39.

> instruments or modification of terms is **accounted for as an extinguishment**, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification **is not accounted for as an extinguishment**, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

35. The requirements in the first half of paragraph B3.3.6 refer to the assessment that an entity is required to make when determining whether the exchange or modified terms of a financial liability are ‘substantially different’. If the difference between the discounted present value of the cash flows under the new terms (including any fees paid net of any fees received) and the discounted present value of the remaining cash flows of the original financial liability is at least 10 per cent, an entity regards the new terms as being significantly different. If that is the case, the entity accounts for the exchange or modification as an extinguishment.

36. The requirements in the second half of paragraph B3.3.6 focus on how to account for any costs or fees incurred depending on whether an entity accounts for the exchange or modification as an extinguishment.

37. The fact that the requirements in paragraph B3.3.6 refer to two different situations as described in paragraphs 35–36 may warrant distinguishing a different nature for the cash flows (including the cash flows relating to fees) to be considered in those situations.

38. We think that the nature of the cash flows that should be considered for the purpose of the ‘10 per cent’ test should be the cash flows exchanged between the parties to the contract (ie the lender and the borrower), because those would be the cash flows directly affected by the changes in the contractual terms. In other words, for the purpose of (quantitatively) assessing the significance of any difference between the new and old contractual terms, only the changes in the contractual cash flows between the lender and borrower are relevant and, thus, should be considered. Consequently, in assessing whether the contractual terms are substantially different, an entity should consider only fees between a lender and a borrower in the ‘10 per cent’ test.

39. In contrast, the fees and costs relating to a modification can be understood as incremental costs directly attributable to the modification. Those costs would not have been incurred if the entity had not modified the financial liability. We think that these costs have a similar nature to 'transaction costs' (see the definition in paragraph 32 of this paper). According to paragraph B3.3.6 of IFRS 9, the accounting treatment of these fees and costs depends on whether the modification triggered the derecognition of the financial liability.

40. In addition, we think that it is consistent with the distinction that the Standard makes between the different items that form part of the calculation of the *effective interest rate* to consider (a) only fees between the lender and the borrower when performing the '10 per cent test', and (b) all fees and costs relating to the modification when accounting for that modification.

Conclusion

41. The staff have analysed whether an entity includes third-party fees when performing the '10 per cent' test by:

    (a) considering the relevance of those fees to the outcome of the test; and

    (b) analysing the requirements in IFRS 9 and IAS 39.

42. On the basis of the analysis undertaken, the staff agree with View 1—that an entity does not consider third-party fees when performing the '10 per cent' test for the purpose of assessing whether to derecognise a financial liability. The staff think that IFRS 9 and IAS 39 sufficiently distinguish fees paid or received between the parties to the contract from other costs, such as transaction costs. The staff also think that this distinction is useful when considering which fees to include when assessing the effect of contractual changes in the cash flows for the purpose of derecognition of a financial liability.

Agenda criteria assessment

43. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:[3]

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No**. On the basis of our analysis of the outreach results received, we do not think the issue is expected to have a material effect on those affected.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Yes**. The responses received from the outreach reflect that there is diversity in practice when entities use IAS 39 and that this is expected to continue when entities apply IFRS 9.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	Not applicable.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable.

[3] These criteria can be found in the *IFRS Foundation Due Process Handbook*.

Staff recommendation

44. As mentioned in paragraph 42, the staff think that the Standards sufficiently distinguish fees paid or received between the parties to the contract from other costs, such as transaction costs. The staff also thinks that this distinction is useful when considering which fees to include in the ‘10 per cent’ test.

45. The outreach results indicated that there is currently diversity in practice between entities applying the requirements in IAS 39 and that this could be expected to persist when entities apply IFRS 9. This is because those requirements were carried forward to IFRS 9 unchanged. Nonetheless, we think that the feedback received from some outreach respondents, stating that in most cases the consideration of third-party fees would not affect the outcome of the ‘10 per cent’ test, alleviates the perceived lack of consistency in the application of the requirements relating to this test.

46. On the basis of the analysis performed, the outreach results and our assessment of the Interpretations Committee’s agenda criteria, we recommend that the Interpretations Committee should not add this issue to its agenda.

47. We have set out proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions for the Interpretations Committee

Questions to the Interpretations Committee
1. Does the Interpretations Committee agree with the staff analysis and recommendation set out in paragraphs 27–47? 2. If the Interpretations Committee agrees with the staff analysis and recommendation, does the Interpretations Committee have any comments on the drafting of the tentative agenda decision set out in Appendix A?

Appendix A—Tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*—Fees and costs included in the '10 per cent' test for the purpose of derecognition

The Interpretations Committee received a request to clarify the requirements in IAS 39 and IFRS 9 relating to which fees and costs should be included in the '10 per cent' test for the purpose of derecognition of a financial liability.

The Interpretations Committee observed the following:

(a) paragraphs AG62 of IAS 39 and B3.3.6 of IFRS 9 require an entity to include 'any fees paid net of any fees received' in the '10 per cent' test when assessing whether the terms of an exchange or modification of a financial liability are substantially different and should be accounted for as an extinguishment of the original financial liability. Those paragraphs also include requirements regarding how to account for 'any costs or fees incurred' relating to the exchange or modification depending on whether that exchange or modification led to the derecognition of the financial liability.

(b) in considering the items to include in the calculation of the effective interest rate, IAS 39 and IFRS 9 distinguish between 'fees and points paid or received between the parties to the contract' and 'transaction costs'. The Interpretations Committee noted that this distinction is useful for the purpose of determining which fees to include in the '10 per cent' test when applying paragraphs AG62 of IAS 39 and B3.3.6 of IFRS 9. The objective of the '10 per cent' test is to quantitatively assess the significance of any difference between the old and new contractual terms by analysing the effect of the changes in the contractual cash flows (ie the contractual cash flows between the lender and the borrower). Consequently, the 'fees' included in the '10 per cent' test are similar to the 'fees and points paid or received between the parties to the contract' included in the calculation of the effective interest rate. In contrast, 'fees and costs' incurred relating to an exchange or a modification have a similar nature to 'transaction costs' in that they are incremental costs directly attributable to the exchange or modification. Those fees and costs would not have been incurred if the entity had not exchanged or modified the financial liability.

On the basis of these observations, the Interpretations Committee concluded that an entity includes only fees between the lender and the borrower in the '10 per cent' test when applying paragraphs AG62 of IAS 39 and B3.3.6 of IFRS 9.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

Wayne Upton Chairman

IFRS Interpretations Committee

30 Cannon Street

London

United Kingdom EC4M 6XH

19 August 2015

Dear Mr Upton

Suggested agenda item: Fees and costs included in the "10 per cent test" for the purpose of derecognition

It has come to our attention that divergent views exist on the question of which fees and costs should be included in a '10 per cent test'. We are seeking clarification of the issue detailed below by the Committee.

Paragraph 3.3.2 of IFRS 9 *Financial Instruments*[4] states that 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.

IFRS 9:B3.3.6 further states that:

> " …the terms are substantially different if the discounted present value of the cash flows under the new terms, including **<u>any fees paid net of any fees received</u>** and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability…" [emphasis added]

Consider an example whereby an entity approaches a lender for a modification of the terms of the loan. Under the modification the borrower is required to pay the lender a fee for rearranging the agreement. In addition to the fee that the borrower pays to the lender it also pays for legal costs to an external third party.

[4] This potential agenda item applies equally to IAS 39 *Financial Instruments: Recognition and Measurement* but for convenience only IFRS 9 references are included.

There is ambiguity as to what is meant by ‘fees paid’ in IFRS 9:B3.3.6 with respect to applying the 10 per cent test. There are, stated from the point of view of the borrower, two views.

View 1 - Only fees paid to, or received from, the lender

Fees included in the 10 per cent are limited to fees paid to, or received from, the lender. The test is intended to capture cash flows between the borrower and the lender that may be referred to as a ‘fee’ but in substance are indistinguishable from the other contractual cash flows of the new debt and hence should be included with the contractual cash flows of the new debt in determining whether the old and new debt are substantially different.

IFRS 9:B3.3.6 specifically states that ‘fees’ paid and received should be included in the discounted present value, but also states that if an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any ‘costs’ or ‘fees’ incurred are recognised as part of the gain or loss on the extinguishment. Those who support View 1 note that costs will include third party costs together with those payable to the lender. The lack of reference to ‘costs’ in the sentence in IFRS 9:B3.3.6 that describes the 10 per cent test would appear to reinforce a view that it is only fees paid to, or received from, the lender, not to other third parties, that are included in the 10 per cent test.

Further, fees paid to a third party are distinguishable as payments for services other than lending and, according to supporters of View 1, should not therefore be included in the 10 per cent test.

Additionally, proponents of View 1 note that the derecognition requirements for financial liabilities in IAS 39 were modelled based on the U.S. GAAP guidance effective at the time the standard was first issued and were intended to be similar. Specifically, the inspiration for the 10 per cent test is found in EITF Issue No. 96-19 (now codified in ASC 470-50-40-12(a) as follows):

> “The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification”

View 2 - Fees payable to, or received from, the lender plus directly attributable third party fees

IFRS 9:B3.3.6 can be read as using the terms ‘costs’ and ‘fees’ synonymously and no distinction should be drawn for the purpose of its application in performing the 10 per cent test. If the intention was only to include cash flows paid or received with the lender, IFRS 9:B3.3.6 would explicitly state this.

Supporters of View 2 also draw an analogy to transaction costs included in the initial carrying value of a financial asset or liability which includes, according to IFRS 9:B5.4.8, fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges and transfer taxes and duties.

It could be seen as inconsistent to define fees narrowly for the purposes of the 10 per cent test, but more widely for the purposes of measuring financial assets and liabilities on initial recognition.

Reasons for the Committee to address the issue

Modification or exchange of debt instruments and the incurrence of costs and fees associated with such transactions are common. The two views presented above can lead to different derecognition conclusions for the same transaction when applying the 10 per cent test resulting in different impacts in profit or loss at the date of modification or exchange. Currently there is diversity in practice.

The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.

Yours sincerely