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STAFF PAPER

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Project	**Annual Improvements to IFRS Standards 2018–2020**
Paper topic	Fees included in the '10 per cent' Test for Derecognition of Financial Liabilities (Amendment to IFRS 9): Analysis of feedback

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Introduction

1. As explained in Agenda Paper 12E, this paper analyses feedback on *Fees included in the '10 per cent' Test for Derecognition of Financial Liabilities* (Proposed amendment to IFRS 9 *Financial Instruments*) included in the Exposure Draft *Annual Improvements to IFRS Standards 2018–2020*. In determining whether to derecognise a financial liability that has been modified or exchanged, an entity assesses whether the terms are substantially different. The proposed amendment would clarify the fees an entity includes when assessing whether the terms of a new or modified financial liability are substantially different from the terms of the original financial liability.

2. We recommend that the International Accounting Standards Board (Board) finalise the proposed amendment to IFRS 9 with no changes.

Structure

3. The paper is structured as follows:

   (a) background (paragraphs 5–10);

   (b) overview of feedback (paragraphs 11–12);

   (c) staff analysis (paragraphs 13–41); and

   (d) staff recommendation (paragraph 42).

4. There is one appendix to the paper: Appendix A—Extract from the Exposure Draft.

Background

5. Paragraph 3.3.2 of IFRS 9 requires:

> 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.

6. Paragraph B3.3.6 states (emphasis added):

> 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 [10 per cent test]. 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. 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.

7. The Board received a request to clarify which fees and costs an entity includes in the 10 per cent test.

8. In its deliberations, the Board observed that the objective of the 10 per cent test is to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows *between the borrower and lender*. Including cash flows paid to or received from parties other than

the borrower and lender would go beyond assessing the difference between the old and new contractual terms.

9. The Board also observed that in considering items to include in calculating the effective interest rate, IFRS 9 distinguishes between ‘fees and points paid or received between the parties to the contract’ and ‘transaction costs’. The fees included in the 10 per cent test are similar to ‘fees and points paid or received between the parties to the contract that are an integral part of the effective interest rate’. In contrast, the reference to ‘costs’ incurred relating to an exchange or modification are similar to ‘transaction costs’ in that they are incremental costs directly attributable to the exchange or modification.

10. Accordingly, the Board proposed to amend paragraph B3.3.6 to clarify that the reference to fees in the 10 per cent test includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other’s behalf. Appendix A to this paper reproduces the proposed amendment to IFRS 9.

Overview of feedback

11. Fifty-two respondents comment on the proposed amendment to IFRS 9. Almost all respondents explicitly agree with the proposed amendment for the reasons outlined in the Basis for Conclusions. Nonetheless, some respondents express concerns about particular aspects of the proposed amendment, including:

    (a) clarity of ‘fees paid or received by either the borrower or lender on the other’s behalf’;

    (b) meaning of, and distinction between, ‘fees’ and ‘costs’; and

    (c) the Board’s decision not to amend paragraph AG62 of IAS 39 *Financial Instruments: Recognition and Measurement*.

12. Further details on these and other matters, together with our analysis, are presented below.

Staff analysis

Clarity of 'fees paid or received by either the borrower or lender on the other's behalf'

Summary of feedback

13. The proposed amendment to paragraph B3.3.6 of IFRS 9 (see Appendix A to this paper) would clarify that a borrower includes in the 10 per cent test only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf.

14. Some respondents suggest the Board clarify the meaning of 'fees paid or received by either the borrower or lender on the other's behalf'. These respondents say the wording is unclear and open to interpretation. A few respondents suggest if the Board's intention is to exclude third-party costs from the 10 per cent test, then the amendment should make this explicit.

15. Some respondents say in some situations, it is unclear how to differentiate between:

    (a) fees paid or received by either the borrower or lender on the other's behalf; and

    (b) cash flows to and from parties other than the borrower and the lender (which would go beyond assessing the difference between the old and new contractual terms and, thus, would not be included in the 10 per cent test—see paragraph 8).

16. Respondents say lack of clarity on this matter could result in (a) structuring opportunities; and (b) diversity in practice. A few of these respondents suggest the Board provide examples of fees paid or received by the borrower or lender on the other's behalf that would be included in the 10 per cent test.

Staff analysis

17. Paragraphs 8–9 of this paper explain the basis for the proposed amendment. The reference to 'fees paid or received by either the borrower or lender on the other's behalf' is not intended to capture transaction costs (see paragraph 9). The Board included this reference to 'fees paid or received…on the other's behalf' to prevent

structuring opportunities whereby for example, a borrower might, instead of paying a fee directly to the lender, agree to pay that amount to a third-party on behalf of the lender.

18. However we agree that the reference in paragraph BC2 of the proposed amendment that '…[i]ncluding cash flows paid to or received from parties other than the borrower and lender would go beyond assessing the difference between the old and new contractual terms' could be confusing. That is because a fee paid or received by the borrower or lender on the other's behalf could be described as a cash flow paid to or received from a party other than the borrower or lender. Therefore, to the extent the wording in paragraph BC2 is carried forward to the final amendment, we will consider clarifying it.

19. We think the Board should not include any examples of fees paid or received by either the borrower or lender on the other's behalf. Assessing whether a particular payment is a fee depends on facts and circumstances considering the objective of the 10 per cent test. The objective (as highlighted in paragraph 8) is to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows *between the borrower and lender*.

20. Accordingly, we recommend no change to the proposed amendment in this respect.

Meaning of, and distinction between, 'fees' and 'costs'

Summary of feedback

21. Some respondents suggest the Board clarify the meaning of, and distinction between, the 'fees' described in the 10 per cent test in paragraph B3.3.6 of the Exposure Draft , and 'any costs and fees incurred' described in paragraph B3.3.6A[1] of the Exposure Draft. For example, EY says:

> It is not clear to us why the proposed wording to paragraph B3.3.6 of IFRS 9 refers only to 'fees' when discussing the 10%

[1] As part of the proposed amendments, the existing requirements in the second half of paragraph B3.3.6 were relocated unchanged to a new paragraph (paragraph B3.3.6A). Appendix A to this paper reproduces these paragraphs.

> test, but to 'fees and costs' in paragraph BC1 in the ED. Likewise, the existing text in re-numbered paragraph B3.3.6A refers to 'costs or fees'. If the intention of the proposed amendment is to distinguish between fees and costs, in our view, this should be clarified in the final amendment. If not, then we recommend using consistent wording.

22. Another respondent (Grant Thornton) says:

> …IFRS 9 does not the define the term "fees" in this context and that providing additional text here may be beneficial in reducing interpretation, so further clarifying this area of accounting. For example, text could be added to clarify that amounts paid or received between the borrower and lender would be included "whether or not they are described as a fee" in order to capture amounts that may be described as other than a fee…

23. The Institute of Public Accountants (Australia) (IPA) says the proposed amendment is too narrow in restricting fees to those between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf. In addition, the IPA and a few other respondents give examples of particular payments and ask whether those amounts are fees that would be included in the 10 per cent test

Staff analysis

24. As discussed in the deliberations leading to the proposed amendment, the purposes of paragraphs B3.3.6 and B3.3.6A in the Exposure Draft are different. Specifically, proposed paragraph B3.3.6 of IFRS 9 (see Appendix A) addresses the assessment of whether the terms of a new or modified financial liability are substantially different from the terms of the original financial liability. Conversely, proposed paragraph B3.3.6A (see Appendix A) addresses the accounting for any costs or fees incurred.

25. As explained in paragraph 9 of this paper, the definition of the effective interest rate in IFRS 9 distinguishes between 'fees and points paid or received between the parties to the contract' and 'transaction costs'. The fees included in the 10 per cent test (discussed in paragraph B3.3.6) are similar to 'fees and points paid or received between the parties to the contract'. In contrast, the 'costs' (discussed in

paragraph B3.3.6A) are similar to 'transaction costs' (ie they are incremental costs directly attributable to the exchange or modification). Because these terms are already used in IFRS 9, we think any further clarification is unnecessary, could have unintended consequences and could go beyond the scope of an annual improvement.

26. Similarly, we think it is not necessary to provide additional examples or address whether particular amounts identified by some respondents are fees. This is because paragraph B5.4.2 of IFRS 9 provides examples of fees that are an integral part of the effective interest rate of a financial instrument and paragraph B5.4.8 of IFRS 9 provides examples of transaction costs.

27. We continue to agree with the Board that the proposals set out in the Exposure Draft are consistent with the objective of the 10 per cent test—ie to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows *between the borrower and lender*.

28. Accordingly, we recommend no change to the proposed amendment in this respect.

Board's decision to not amend paragraph AG62 of IAS 39

Background and summary of feedback

29. The requirements in IAS 39 for the derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9. Consequently, the requirements in paragraph B3.3.6 of IFRS 9 are the same as the requirements in paragraph AG62 of IAS 39. The Board considered, but decided not to, propose amending paragraph AG62 of IAS 39. Paragraph BC4 of the proposed amendment explains:

> If an entity's activities are predominantly connected with insurance and it has not previously applied any version of IFRS 9, the entity is permitted to apply IAS 39 for annual reporting periods beginning before 1 January 2021.[2] The Board considered, but decided against, proposing an amendment to

[2] In June 2019 the Board proposed in the Exposure Draft *Amendments to IFRS 17* that the fixed expiry date in IFRS 4 *Insurance Contracts* for the temporary exemption from applying IFRS 9 should be amended so that all entities would be required to apply IFRS 9 for annual reporting periods beginning on or after 1 January 2022.

paragraph AG62 of IAS 39. This is because any such amendment would:

(a) apply only to a limited number of entities;

(b) apply only for a limited period of time (that is, from the effective date of the amendment until the effective date of IFRS 17 *Insurance Contracts*); and

(c) affect only those entities that include third-party fees in the 10 per cent test.

30. Some respondents disagree and suggest the Board amend paragraph AG62 of IAS 39. In these respondents' view, it is important that the requirements in IFRS 9 and IAS 39 remain aligned in this respect. Respondents say the benefits of aligning the requirements would outweigh any 'negligible cost' of amending IAS 39. EY says:

> …While we understand the practical arguments put forward to support not making changes to IAS 39, we question whether this will set a precedent for future possible amendments (or non-amendments), for example, IBOR phase two amendments to the portions of IAS 39 not currently contained in the IFRS Books. While insurance companies continue to be permitted to apply IAS 39, it is not feasible to totally 'freeze' IAS 39 in its 2017 form.

31. In addition, IFRS for SMEs allows an entity to apply the recognition and measurement requirements in IAS 39 to all its financial instruments. EY suggests the Board amend IAS 39 because that Standard continues to be relevant for some entities applying IFRS for SMEs.

Staff analysis

32. We continue to think the Board should not amend paragraph AG62 of IAS 39 for the reasons discussed in paragraph BC4 (see paragraph 29 above).

33. If the Board proceeds with finalising the Annual Improvements, we expect to recommend an effective date of annual reporting periods beginning on or after 1 January 2022. We therefore see little, if any, benefit in amending paragraph AG62 of IAS 39 in the light of the limited number of entities that can still apply that

paragraph for a limited period of time. Given the temporary nature of the exemption from applying IFRS 9, maintaining IAS 39 (other than for hedge accounting) has not been contemplated. In addition, the proposed amendment to IFRS 9 is clarifying in nature and, thus, entities applying IAS 39 can already apply the accounting being clarified in the amendment.

34. We agree that some entities that apply IFRS for SMEs might choose to apply the recognition and measurement requirements in IAS 39. As discussed in paragraph 33 above, such entities would be able to apply the accounting treatment clarified in the amendment to IFRS 9, without a change being made to IAS 39.

35. We also note that footnote 1 to paragraph 11.2(b) of IFRS for SMEs states (emphasis added):

> …When IAS 39 is superseded by IFRS 9, an entity shall apply the version of IAS 39 *that applied immediately prior* to IFRS 9 superseding IAS 39…

36. Accordingly, changing IAS 39 for entities applying IFRS for SMEs would also require amending this footnote—in our view, this goes beyond the scope of this annual improvement.

37. Accordingly, we recommend no change to the proposed amendment in this respect.

Proposed transition requirements

Background and summary of feedback

38. The Board proposed that an entity apply the amendment to financial liabilities that are modified or exchanged on or after the date it first applies the amendment (ie prospective application). Paragraph BC3 of the proposed amendment explains:

> …In the Board's view, the expected benefits of retrospectively applying the proposed amendment would not outweigh the potential costs. The Board found that:
>
> (a) retrospective application might be difficult and costly for some entities because it could require reassessment of all previous modifications and exchanges. There may also be little

benefit from such reassessment because it might often result in no change in the previous assessment of the significance of the difference in contractual terms.

(b) financial liabilities are generally modified or exchanged on an ad hoc basis. Consequently, restating comparative information would be unlikely to provide users of financial statements with trend information.

39. Only 13 respondents commented on the proposed transition requirements—all of these respondents agree with the proposed transition requirements for the reasons explained in paragraph BC3 of the proposed amendment.

Staff analysis

40. We continue to agree with the proposed transition requirements and recommend finalising these requirements (ie requiring an entity to apply the amendment to financial liabilities that are modified or exchanged on or after the date it first applies the amendment).

Other comments

41. The table below summarises other comments together with our analysis.

Comments	**Staff analysis**
1. *Modifications or exchanges of financial assets* A few respondents suggest that the Board make a similar amendment to the requirements for modifications or exchanges of financial assets. EY also notes the interaction between the wording used in the accounting for modifications that do not result in	*We recommend no change to the proposed amendment in this respect.* Considering the requirements for modifications or exchanges of financial assets goes beyond the scope of this annual improvement. We will review the wording of paragraph BC2 to the extent it is carried forward to the final amendment.

Comments	Staff analysis
derecognition and the wording in paragraph BC2.	
2. Inconsistency with IFRIC 19 The IPA said the proposed amendment could lead to an outcome that could be inconsistent with IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* in a situation in which an entity pays a fee with equity instruments.	*We recommend no change to the proposed amendment in this respect.* IFRIC 19 addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. IFRIC 19 does not contain requirements related to the fees that are included in the 10 per cent test. Accordingly, in our view the proposed amendments are not inconsistent with IFRIC 19.
3. Drafting suggestions Some respondents provided drafting suggestions. In addition, EY says the wording in the introductory text for the proposed amendment to IFRS 9 could imply that the 10 per cent test is the only appropriate method for assessing whether a modification of a financial liability is substantial.	*We will consider these suggestions when drafting the final amendments.* The introductory text in the Exposure Draft is included to provide context and explanation. In our view it does not imply that the 10 per cent test is the only appropriate method for assessing whether a modification of a financial liability is substantial; nonetheless, we will review the wording to the extent it is carried forward to the final amendments.

Staff recommendation

42. We recommend that the Board finalise the proposed amendment to IFRS 9 with no changes.

Question 1 for the Board
Does the Board agree with the staff recommendation to finalise the proposed amendment to IFRS 9 with no changes?

Appendix A—Extract from Exposure Draft

A1. This appendix reproduces relevant excerpts from the Exposure Draft.

[Draft] Amendment to IFRS 9 *Financial Instruments*

…paragraph B3.3.6A are added. Paragraph B3.3.6 is amended. New text is underlined.

…

Appendix B

Application Guidance

This appendix is an integral part of the Standard.

…

Recognition and derecognition (Chapter 3)

…

Derecognition of financial liabilities (Section 3.3)

…

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. <u>In determining those fees paid net of fees received, a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf.</u>

<u>B3.3.6A</u> 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. 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.

…