IFRS

IFRS Interpretations Committee Meeting

Staff Paper

Agenda reference **6**

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Project **New items for consideration**

Topic **IAS 39 *Financial Instruments: Recognition and Measurement*—Determining the effective interest rate of restructured Greek Government bonds**

Introduction

1. In April 2012, the IFRS Interpretations Committee (the Committee) received a request for guidance on the accounting for several different aspects of restructuring of Greek government bonds (GGBs). The principal issue raised is whether this transaction should result in derecognition of the whole asset, or only part of it, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). The submission contained six questions (the submission is attached as Appendix B to this paper.). The Committee addressed five of those questions at its May meeting (the [Draft] tentative agenda decisions are reproduced in Appendix C to this paper).

2. This paper only addresses Question E, which is about how to determine the effective interest rate (EIR) for the new bonds received as part of the GGB restructuring.

Objective

3. The objective of this paper is to provide:

   (a) background information on issue #5 of the submission (that corresponds to Question E); and

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

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

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

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(b) the staff analysis of issue #5.

A reminder of the main features identified in the submission

4. The submission describes a fact pattern in which the bondholders exchange their existing holdings of GGBs (irrespective of their maturity and terms and conditions) by surrendering them for new bonds issued by the same issuer. Further details of the fact pattern are described in agenda papers 10A to 10C presented at the May 2012 Interpretations Committee Meeting.
5. The submitter raised various questions relating to *derecognition* of the old GGBs that were exchanged for new bonds of the same issuer. Given the Committee's tentative agenda decision at the May meeting, ie that the old GGBs must be derecognised and the new bonds must be recognised as new assets, the question arises how the EIR for those new bonds should be determined.

Staff analysis

The issue

6. Question E in the submission relates to whether it is possible to apply paragraph AG5 of IAS 39, when determining the EIR of the newly recognised Greek bonds. This means the question is about the *scope* of paragraph AG5: whether calibrating the EIR includes adjusting the cash flows for incurred losses that exist on initial recognition of an asset for:

   (a) purchased *and originated* assets; or

   (b) only to purchased assets (but *not* to originated assets).
7. The staff note that Question E is only relevant if the newly recognised asset is classified within a category of financial assets that involves applying the effective interest method, ie a category other than at fair value through profit or loss.

What is the scope of paragraph AG5 of IAS 39?

8. The staff analysis uses the following criteria in determining what the scope of paragraph AG5 is:

   (a) the wording of the requirement;

   (b) the context and structure of IAS 39; and

   (c) the purpose of the requirement.

The wording of the requirement

9. Paragraph AG5 of IAS 39 says [emphasis added]:

   > In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

   The reference to 'acquired' assets might raise the question whether it comprises only purchased assets or also originated assets.

10. IAS 39 uses the terms 'acquired' and 'acquisition' in various instances as a generic term that comprises both purchases and originations of assets. For example:

    (a) The definition of the category at fair value through profit or loss (in paragraph 9), which applies to assets irrespective of whether they are purchased or originated [emphasis added]:

    > *A financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions.
    >
    > (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if:
    >
    > (i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; […]

    (b) The definition of transaction costs (in paragraph 9), which applies to assets irrespective of whether they are purchased or originated [emphasis added]:

> *Transaction costs* are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

(c) Paragraph 43 on initial measurement, which applies to all assets irrespective of whether they are purchased or originated [emphasis added]:

> When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

11. Also, the Committee previously concluded at its March 2009 meeting in the context of a submission regarding loan syndications that the use of 'acquired' in IFRSs includes the notion of 'originated'.

12. **Conclusion**: the wording of paragraph AG5 is compatible with applying the requirement to financial assets that are originated.

The context and structure of IAS 39

13. Paragraph AG5 is part of the section[1] in the application guidance that elaborates on the defined terms that IAS 39 uses. Paragraph AG5 provides additional guidance on how to determine the effective interest rate, which is at the centre of the *effective interest method* (as defined in paragraph 9 of IAS 39).

14. The effective interest method in IAS 39 applies to all categories of financial assets for which the calculation of interest revenue is required:

    (a) Loans and receivables (IAS 39.46(a));

    (b) Held-to-maturity investments (IAS 39.46(b)); and

    (c) Available-for-sale debt instruments (IAS 39.55(b)).

[1] Paragraphs AG5 to AG8 of IAS 39.

15. IAS 18 *Revenue* also requires that interest revenue is recognised using that same effective interest method (IAS 18.30(a) refers to IAS 39.9 and AG5 to AG8).

16. Hence, IAS 39 has only one effective interest method[2] that:

    (a) includes paragraph AG5; and

    (b) is used for all instances that require interest revenue to be calculated on an effective interest basis.

17. **Conclusion**: the context and structure of IAS 39 means that paragraph AG5 is an integral part of the effective interest method and hence applies to all financial assets for which interest revenue is calculated on an effective interest basis, including assets that are originated.

The purpose of the requirement

18. The Basis for Conclusions on IAS 39[3] says with regard to paragraph AG5 [emphasis added]:

> The Board also decided to clarify that expected future defaults should not be included in estimates of cash flows because this would be a departure from the incurred loss model for impairment recognition. At the same time, the Board noted that in some cases, for example, when a financial asset is acquired at a deep discount, credit losses have occurred and are reflected in the price. If an entity does not take into account such credit losses in the calculation of the effective interest rate, the entity would recognise a higher interest income than that inherent in the price paid. The Board therefore decided to clarify that such credit losses are included in the estimated cash flows when computing the effective interest rate.

19. This highlights the rationale for including the requirement in paragraph AG5 in the application guidance for the effective interest method. The purpose of

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[2] See also IAS 39.BC30 ("The Board considered whether the effective interest rate for all financial instruments should be calculated on the basis of estimated cash flows (consistently with the original IAS 39) or whether the use of estimated cash flows should be restricted to groups of financial instruments with contractual cash flows being used for individual financial instruments. The Board agreed to reconfirm the position in the original IAS 39 because it achieves consistent application of the effective interest method throughout the Standard." [emphasis added]).

[3] See IAS 39.BC32.

including incurred credit losses in the cash flow estimate that is used to calibrate the EIR is to *avoid overstating interest revenue* in those extreme situations in which already on initial recognition of the asset there is objective evidence of impairment (ie there has already been a loss event).

20. Without including those credit losses in calibrating the EIR, interest revenue would be recognised at a rate that would result in the deeply discounted carrying amount being written up to the repayment amount over the remaining life of the asset (assuming collection of all interest cash flows). However, given that an incurred loss exists on initial recognition of the asset, even on initial recognition the collection of all the contractual cash flows is not probable.[4] Still recognising revenue using an EIR whose calibration excludes the incurred loss would have the following consequences:

    (a) an inconsistency with the revenue recognition requirements of IAS 18[5];

    (b) overstating interest revenue and necessitating the immediate recognition of an 'automatic impairment' (see the example in paragraph 22 and the explanation in paragraph 28).

21. Calibrating the EIR ignoring the incurred loss would be **inconsistent with IAS 18** because that standard requires as a precondition for recognising revenue that "it is probable that the economic benefits associated with the transaction will flow to the entity"[6]. Because an incurred loss exists on initial recognition, this requirement is not fulfilled given that collection of all the contractual cash flows is not probable—see paragraph 20 above.

22. The **overstatement of interest revenue and the 'automatic impairment'** would result from the fact that the existence of an incurred loss right from initial

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[4] The fact that the collection is not probable follows from the examples of a loss event in IAS 39.59. (In fact, an earlier version of IAS 39 that used those loss events described the moment when an impairment loss occurs as it being "…probable that an enterprise will not be able to collect all amounts due (principal and interest) according to the contractual terms…" (IAS 39(1998), paragraph 111.)

[5] IAS 18 also applies to recognition of interest revenue—see paragraph 15 of this paper and IAS 18.29.

[6] See IAS 18.29(a).

recognition means that at the next reporting date the carrying amount[7] of the asset has to be determined as the present value of the cash flows still expected to be received (after taking into account the credit loss), using the original EIR (that would have been calibrated excluding the incurred loss) for discounting.[8] The effect of this is illustrated by the following simple example[9]:

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[7] For the sake of simplicity, the staff analysis illustrates the issue using assets that are measured at amortised cost. However, for available-for-sale financial assets interest revenue is also determined using the effective interest method (see paragraph 14 of this paper) and similar considerations apply (see also Question E.3.2 of the Implementation Guidance for IAS 39).

[8] See IAS 39.58 and 63.

[9] Numbers are not in debit/credit format but positive for asset and revenue amounts and negative for loss amounts. The example displays numbers using rounding to one decimal but the underlying calculations use a higher precision—hence, totals can include 'rounding errors'.

Purpose of IAS 39.AG5—illustration

Fact pattern

Principal	100.0
Interest	5%
FV on acquisition	24.0
EIR (without AG5)	75.2%
EIR (with AG5)	17.5%

Remaining CFs (on initial recognition) **[periods]**	**1**	**2**	**3**	**4**
Contractual	-24.0	5.0	5.0	105.0
Expected	-24.0	5.0	0.0	32.0

Accounting

Not applying AG5

A				
Carrying amount				
Amortised cost	24.0	37.1	64.9	81.8
FV on initial recognition	24.0			
Interest revenue		18.1	27.9	48.8

B				
Effect of 'additional impairment'				
Carrying amount				
Amortised cost	8.8	10.4	18.3	32.0
FV on initial recognition	24.0			
Interest revenue		6.6	7.8	13.7
'Impairment' (upfront loss)	-15.2	0.0	0.0	0.0

Applying AG5

C				
Carrying amount				
Amortised cost	24.0	23.2	27.2	32.0
FV on initial recognition	24.0			
Interest revenue		4.2	4.1	4.8

23. An entity acquires a debt instrument at the end of Period 1 for a fair value of CU24. The asset's principal amount is 100 and it bears annual coupon interest of 5%. Even though there is an incurred loss, the entity expects to still collect the next interest coupon at the end of Period 2 but thereafter only the recovery cash flow after default of CU32 at the end of Period 4. The example assumes that this estimate becomes the actual outcome (ie there is no change in the loss estimate and consequently—from an economic perspective—no impairment because all cash flows that on initial measurement of the asset were expected to be collected are actually collected).

24. The EIR calibrated without applying paragraph AG5 (ie ignoring the incurred loss) is 75.2%. When applying paragraph AG5 (ie including the incurred loss in the cash flow estimate used for calibrating the EIR) the EIR is 17.5%.

25. If the effective interest method was applied using the EIR of 75.2% without recognising an 'impairment loss', the carrying amount of the asset would not unwind to the future cash flows. This is accounting scenario **A** in the illustration. Scenario **A** is only intended to illustrate that in isolation this accounting would not work.

26. Hence, as illustrated in accounting scenario **B**, if the effective interest method was applied using the EIR of 75.2% it would necessitate recognising an 'impairment loss'—even though from an economic perspective the entity does not have any impairment loss (the initial carrying amount of the asset—its fair value—reflected cash flow expectations that include the effect of credit losses). To the contrary, what might look like an impairment loss is in effect an upfront loss that results from a measurement mismatch at the time of initial recognition of the asset:

    (a) the asset's fair value is CU24 *whereas*

    (b) the present value of the cash flows *expected to be received* discounted using the EIR is CU8.8 (this is the 'amortised cost' immediately after the initial measurement because the fact that there is an incurred loss requires the cash flow estimate to take that loss into account whereas not applying paragraph AG5 meant the incurred loss was ignored when calibrating the EIR).

27. Hence, the inconsistency between the cash flow estimate that must be used for measuring the carrying amount of an asset that has an incurred loss and the cash flow estimate used for calibrating the EIR creates *mathematically* a difference between fair value and the amortised cost when it would be calculated at the date of the initial recognition of the asset. This difference does *not* represent any

economic phenomenon, in particular not any deterioration of the credit quality of the asset.

28. As scenario **B** illustrates, the inconsistency between the different cash flow estimates technically necessitates recognising a 'loss' on day 1 (CU-15.2).[10] It also results in an amortised cost carrying amount that is below fair value, which is inconsistent with the initial measurement required under IAS 39[11] and the definition of the effective interest method, which have a combined effect of requiring that those two amounts are identical on initial recognition.[12]

29. Scenario **B** also illustrates that interest revenue would be overstated (in effect including some of the losses incurred on initial recognition). The amount recognised as 'interest revenue' over the total holding period to maturity would be CU28.2[13] whereas the *actual* total interest over that period is only CU13.[14] Consequently, the amounts presented as interest revenue are inconsistent with an effective yield concept (which the effective interest method represents).

30. Scenario **C** illustrates the application of paragraph AG5. In this case the accounting is fully consistent with the requirements in IAS 39:

    (a) On initial recognition, the asset's amortised cost equals its fair value (and consequently there is no 'day 1 loss' to technically 'bridge' a gap between those amounts).

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[10] If the reporting date is not immediately after initial recognition of the asset this effect would be masked by accounting for interest revenue and any changes in loss estimates during the period to the next reporting date.

[11] Which is fair value (see IAS 39.43—the example assumes there are no transaction costs).

[12] Even though amortised cost is a subsequent measurement, in this example the acquisition is assumed to be in the 'logical second' before the reporting date so the first subsequent measurement equals the initial measurement.

[13] Sum of interest revenue of CU6.6, CU7.8 and CU13.7 over Periods 2 to 4.

[14] Coupon interest of CU5 in Period 2 and discount interest of CU8 (which is the recovery cash flow of CU32 less the initial fair value of CU24). NB: the effective interest method only determines the timing of the recognition of the total period interest—the total amount of the interest over the total period is given by the net cash flow surplus of all cash flows involved.

(b) The amount recognised as interest revenue over the total period equals the actual total interest revenue CU13[15].

31. **Conclusion**: taking the incurred loss into account when calibrating the EIR:

(a) achieves the purpose of avoiding overstating interest revenue (by including in the calibration of the EIR credit losses that are incurred already on initial recognition);

(b) avoids inconsistencies with the requirements of IAS 39;

(c) results in a faithful representation of the economic phenomenon.

Conversely, if the EIR is calibrated ignoring the incurred loss, the resulting accounting defeats the purpose of avoiding overstatements of interest revenue (and conflicts with other IAS 39 requirement and faithful representation). This conclusion applies to *purchased and originated assets alike* (the accounting mechanics illustrated by the examples are the same for both cases). Consequently, when an incurred loss exists on initial recognition of an asset to which the effective interest method applies, the staff consider that paragraph AG5 must be applied irrespective of whether an asset is purchased or originated.

Overall conclusion on the scope of paragraph AG5 of IAS 39

32. The staff analysis covered the aspects of the wording of the requirement, the context and structure of the standard, and the purpose of the requirement. The conclusions on each of those aspects are all consistent—the scope of paragraph AG5 *includes a*ssets that are originated. Consequently, this is also the overall conclusion.

33. This means that even though an origination of a debt instrument with an incurred loss is rather unusual, if it does happen, in the staff's view the accounting must follow paragraph AG5. In the context of significant financial difficulty of an obligor transactions can arise that involve originations of debt

[15] Sum of interest revenue of CU4.2, CU4.1 and CU4.8 over Periods 2 to 4, which totals CU13.

instruments that are outside the normal underwriting process but instead forced upon already existing lenders by the restructuring process. This could include situations in which modifications of debt instruments result in derecognition of the original financial asset and the recognition of a new financial asset under IFRSs. 'New' financial assets could be recognised in these circumstances that have incurred losses on initial recognition.

34. Because they are rather unusual, such 'forced' originations might not have been envisaged when IAS 39 was originally developed. That could be the reason why the Basis for Conclusions refers to "price paid"[16], which implies a purchase. However, it is only an example that illustrates why the Board took the decision when deliberating IAS 39. It is a typical feature of the standard setting process to use some key examples to develop an accounting model, which then applies much more widely (otherwise it would not be a model). Hence, an example in the Basis for Conclusions that illustrates the Board's rationale cannot be construed to be authoritative for the scope of a requirement (at least not in the context of principle-based standard setting). Moreover, the staff analysis demonstrates that the rationale underlying this decision could equally apply to both originated and purchased financial assets.

Agenda criteria assessment

35. The staff's preliminary assessment of the agenda criteria based on its knowledge and experience is as follows:

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

    No.

    We understand that originations of debt instruments with incurred credit losses are uncommon and any failure to reach consensus is not widespread.

[16] See IAS 39.BC32.

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

No.

We regard IFRSs as clear on this issue. Therefore we do not expect significant divergence in practice.

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

Not applicable: it has not come to the staff's attention that diverse reporting methods have already evolved.

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

Not applicable: given that IFRSs are clear the Committee's interpretation process would not be pertinent.

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

Not applicable. see item (d) above.

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

The issue relates to the IASB's project on an expected loss based impairment model for financial assets, which will consider how amortised cost (using an effective yield concept) should apply to assets that have a high credit risk on initial recognition. In addition, as noted above, the staff consider IFRSs are already clear on this issue in the context of IAS 39.

Staff recommendation

36. In the staff's view IFRSs are clear on the issue: the scope of paragraph AG5 of IAS 39 *includes* assets originated by the holder. Based on the resulting assessment of the agenda criteria, the staff do not recommend that the Committee take this issue onto its agenda.

Questions for the Committee
1. Does the Committee agree that the scope of paragraph AG5 of IAS 39 *includes* assets originated by the holder? 2. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1 The staff propose the following wording for the tentative agenda decision:

IAS 39 *Financial Instruments: Recognition and Measurement*—Scope of paragraph AG5

The Interpretations Committee (the Committee) received a request for guidance on the circumstances in which the restructuring of Greek government bonds (GGB) should result in derecognition of the whole asset, or only part of it, in accordance with IAS 39 *Financial Instruments Recognition and Measurement* (IAS 39). In particular, the Committee has been requested to consider whether paragraph AG5 of IAS 39 could apply when determining the effective interest rate on initial recognition of the new GGBs that were received as part of the debt restructuring. Applying paragraph AG5 means that the effective interest rate would be determined at initial recognition using estimated cash flows that take into account incurred credit losses.

The Committee noted that the use of the word 'acquired' in IAS 39 is not limited to purchase transactions but includes the notion of 'originated'.

The Committee further noted that the context and structure of IAS 39 means that paragraph AG5 is an integral part of the effective interest method and hence applies to all financial assets for which interest revenue is calculated on an effective interest basis, including assets that are originated.

The Committee also considered the purpose of paragraph AG5. The Committee noted that taking incurred credit losses into account when determining the effective interest rate would:

(a) achieve the purpose of avoiding overstating interest revenue;

(b) avoid inconsistencies with the requirements of IAS 39; and

(c) result in a faithful representation of the economic phenomenon.

The Committee emphasised that this analysis applies to purchased and originated assets alike.

Consequently, the Committee reached an overall conclusion that the scope of paragraph AG5 includes assets originated by the holder.

The Committee also noted that even though an origination of a debt instrument with an incurred loss is rather unusual, there are situations in which such transactions occur. For

example, in the context of significant financial difficulty of an obligor transactions can arise that involve originations of debt instruments that are outside the normal underwriting process but instead forced upon already existing lenders by a restructuring process. This could include situations in which modifications of debt instruments result in derecognition of the original financial asset and the recognition of a new financial asset under IFRSs. In these circumstances, new financial assets could be recognised that have incurred losses on initial recognition.

The Committee considered that in the light of its analysis of the existing requirements of IAS 39 an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.

Appendix B–Request for interpretation

B1 The staff received the following submission from the European Securities and Markets Authority (ESMA). All information has been copied without modification and is shown below.

European Securities and Markets Authority

RESTRICTED
Date:17 April 2012
ESMA/2012/248

IFRS IC
Wayne Upton

IASB
Cc: Hans Hoogervorst

Cannon Street 30
London EC4M 6XH
United Kingdom

Accounting exposure to Greek sovereign debt

Dear Mr. Upton,

Further to the 26 October 2011 Euro Summit Statement, the Hellenic Republic announced on 21 February 2012 the key terms of a voluntary transaction, known as the Private Sector Involvement (the "transaction"). This transaction was conducted in the context of the Greek economic reform program that has been agreed with the European Union and the International Monetary Fund. The transaction involves an invitation to private sector holders of Greek Government Bonds (GGBs) to exchange their holdings with new bonds to be issued by the Hellenic Republic.

ESMA has now considered the implications from the transaction for European issuers and preparers of IFRS financial statements in particular. ESMA considers that IAS 39 – *Financial Instruments: Recognition and Measurement* does not provide explicit guidance on the accounting treatment of a debt exchange or more generally the modification of terms for financial assets. This results in difficulties to understand how the standard should be applied to the bond exchange and could raise enforceability issues.

ESMA has identified different rationales that can be followed in analysing an exchange as either a derecognition or as a modification in terms of a financial asset. These rationales are detailed in the

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appendix to our letter and are illustrated with the main characteristics of the Greek Private Sector Involvement exchange.

While for this specific case ESMA identified strong arguments to account the transaction as a derecognition of the original financial asset, we anticipate difficulties in terms of enforceability in case a different approach would be followed by issuers.

ESMA would wish to have your views as to whether the rationales outlined in this appendix are in line with the principles set out in IFRS. Due to the lack of explicit guidance on a type of transaction that is quite widespread and the importance for the financial markets and investors, ESMA would also invite the IFRS Interpretations Committee to clarify the standard.

We would be happy to further discuss these issues with you.

Yours sincerely,

Julie Galbo
Chair Corporate Reporting Standing Committee

Steven Maijoor
ESMA Chair

APPENDIX – ESMA's detailed comments on the application of IAS 39 to the transaction

The objective of this appendix is to set out the rationale followed in identifying the appropriate accounting treatment to be applied to this transaction, the characteristics of which are described in the background section below. Several interpretations of IAS 39 are considered to be possible in this case.

A. Background of the transaction

1. The Hellenic Republic announced on 21 February 2012 the key terms of a voluntary transaction further to the 26 October 2011 Euro Summit Statement, known as the Private Sector Involvement, and in the context of its economic reform program, that has been agreed with the European Union and the International Monetary Fund. The transaction involves an invitation to private sector holders of certain Greek Government Bonds (GGBs) to exchange their holdings with new bonds to be issued by the Hellenic Republic.

2. The key terms applicable to each eligible privately held GGB are as follows :

   (a) 53.5% of the principal amount of the GGB will be forgiven;

   (b) 31.5% of the principal amount of the GGB will be exchanged into 20 new Greek government bonds with maturities of 11 to 30 years; and

   (c) the remaining 15% will be in short-dated securities issued by the European Financial Stability Facility (EFSF).

3. The coupon on the new Greek government bonds under (b) above will be structured so that it will be 2% for the three years period from February 2012 to February 2015; then 3% for the following five years (February 2015 to February 2020); and 4.3% for the period from February 2020 to February 2042.

4. Securities linked to the Gross Domestic Product (GDP): subscribers to the plan will receive, for each new bond, a GDP linked security of an initial nominal amount of €100. Holders of this security are not entitled to receive principal in the amount of, or interest based on, the notional amount. The only amounts payable in respect of these securities are the payments contingent upon and determined on the basis of the performance of the gross domestic product of the Hellenic Republic.

5. All issuers will obtain 20 new bonds for each old bond with different maturities irrespective of their former portfolio.

6. Public companies involvement: other Greek public institutions (such as the Public Railway Company, Athens Urban Transport Organisation etc) are included in the PSI. The characteristics of the exchange are the same, i.e. they receive GGBs with the same terms as those for other bondholders.

B. IFRS requirements considered as part of the analysis

De-recognition of financial assets:

7. The requirements for de-recognition of financial assets as set out in IAS 39 paragraphs 16-23 emphasise the expiration of rights to receive cash flows and transfer of risk and rewards associated with the ownership of the asset. Nevertheless they do not address specifically cases of exchange of debt instruments or substantial modification from the lender's perspective as a consequence of a troubled debt restructuring due to financial difficulty of the borrower.

8. On the other hand, when there is a debt exchange or modification of terms of an existing financial liability, IAS 39 paragraph 40 explains how an exchange should be differentiated from an extinguishment. It is not explicit in the standard that an exchange must automatically, by its legal form, lead to an extinguishment or expiry of bonds.

C. Analysis of the transaction

9. The first consideration is whether to apply de-recognition to the whole asset, or only a part of it, in accordance with IAS 39 paragraph 16. Since the proportionate shares of cash-flows can be specifically identified, it is considered that IAS 39 paragraph 16 (a) (ii) is applicable. Analysis of the elements included in the deal led to the conclusions that:

   (a) The 53.5% part of the original asset to be forgiven has to be derecognized in accordance with IAS 39 as no future cash flows are to be received from that part of the asset (IAS 39 paragraph 17(a)).

   (b) The 15% part of the original asset that will be exchanged against short term securities from EFSF has to be derecognized as those cash flows are transferred and replaced with instruments issued from a different counterpart, with different characteristics and credit risk (IAS 39 paragraph 17(b)).

10. While there is general agreement that the parts mentioned above should be de-recognised, there is a lack of consensus over the IFRS accounting treatment of the 31.5% part of the old bond to be exchanged against the new 20 bonds with different maturities and interest rates ("the exchange"). The rest of this note is concerned only with this element of the transaction.

11. On the basis of this analysis there appears to be two possible outcomes which can be supported under IFRS for the exchange: de-recognition of the original asset or modification of the original asset. The chart attached at the end of the appendix illustrates the different rationales followed in the analysis.

D. Analysis of the exchange

12. In analysing the exchange, the preliminary step was to identify what the relevant IFRS requirements are and to determine whether IAS 39 contains specific principles to be applied to the exchange of bonds **from the lender's perspective**. In answering that question, two approaches have been identified.

Approach A:

13. Even if IAS 39 does not make any specific reference to "exchange" of financial assets, the derecognition criteria specified under IAS 39 paragraphs 16 to 23 are relevant and should be used in order to determine whether the old bond should be de-recognised or not.

Approach B:

14. IAS 39 does not provide any specific guidance related to an "exchange" of financial assets from the lender's perspective. Therefore, bondholders should choose another accounting method by applying IAS 8 – *Accounting Policies, Changes in Accounting Policies* paragraphs 10 to 12. Paragraph 11 states that the first source of information to be used in making a judgement about the accounting policy to be applied is the requirements of IFRS dealing with similar and related issues.

D.1. Approach A

15. Following approach A, the de-recognition steps from IAS 39 paragraph 17-23 are analysed in detail.

Question 1: Does the exchange fall under the scope of IAS 39 paragraph 17 (a)?

16. IAS 39 paragraph 17(a) requires an entity to derecognise a financial asset when "the contractual rights to the cash flows from the financial assets expire". Since there is no definition of the concept of "expiration" of cash flows, the questions arises whether the Greek exchange can be considered under this category.

View 1: de-recognition is appropriate under IAS 39 paragraph 17(a)

17. From a legal and stricto sensu approach, the exchange implies that the cash-flows from the original asset are not due anymore, and therefore they are considered expired. Therefore the original asset has to be derecognised.

18. Alternatively, an entity might perform a quantitative and qualitative evaluation of whether the cash flows of the original bond against the new instruments to be received are substantially different. By looking to the substance of the exchange, it can be concluded that the substitution of the 31.5 % of an old bond with 20 new bonds with changed maturities and coupons involves significant changes in the contractual terms and future cash flows. These cannot be considered as a revision of estimated cash flows as is dealt with in IAS 39 paragraph AG8, but should rather be viewed as an expiration of the cash flows from the 31.5 % of the old bond. Accordingly, the 31.5 % of the old bond should be derecognised in accordance with IAS 39 paragraph 17(a).

View 2: de-recognition is not appropriate under IAS 39 paragraph 17(a)

19. If it is considered that the contractual rights to receive the cash flows of the "original" financial asset have expired, it would mean that there is no exchange de facto. The Greek debt would have expired because of a full forfeiture of the cash flows. As a result, the deliverance of the new bonds would not be part of any exchange and the new bonds received should be considered as a grant from the Greek Government.

20. There is no expiration from the bondholder's perspective but only a transfer of the original cash flows in consideration for the new bonds received from the Greek Government. The fact that the Greek Government will cancel the "old" bonds received by setting them off against its own liability will only have an impact on the Greek Government and not on the bondholders.

21. The arguments above support the view that the contractual rights to receive the cash flows of the "original" financial asset have not expired, but effectively continue through the granting of the new bonds. Consequently IAS 39 paragraph 17(a) would not apply and the new bonds would be in effect a modification of the old bonds.

Question 2: Does the exchange fall under the scope of IAS 39 paragraph 17 (b)?

22. IAS 39 paragraph 17(b) requires an entity to derecognize a financial asset when the entity transfers (IAS 39 paragraphs18 and 19) the financial asset and the transfer qualifies for de-recognition (IAS 39 paragraph20). The standard does not define the concept of "transfer", but indicates the criteria to be fulfilled for a transaction to qualify as a "transfer".

View 1: exchange does not fall within scope of IAS 39 paragraph 17(b)

23. In the absence of a definition of a "transfer", this notion is interpreted by some as implying a transfer to a third party. In the case of the Greek exchange, the counterparties are the same and therefore this does not fall under IAS 39 paragraph 17(b). Therefore, in accordance with this view, **de-recognition based on this criterion is not possible.**

View 2: exchange does fall within scope of IAS 39 paragraph 17(b)

24. An exchange can be seen as constituting a form of transfer in that the cash flows of the old bonds are transferred back to the Greek Government, in exchange for the new bonds. Further analysis of the conditions under which the exchange is done is needed in order to evaluate the extent to which a bondholder retains the risk and rewards of ownership (IAS 39 paragraph20 to 23). This view is further analysed under Question 3.

Question 3: Are risk and rewards related to the exchange transferred [IAS 39 paragraph20]

25. Once an entity has established that it has transferred a financial asset, it should carry out the risks and rewards test. IAS 39 paragraph 21 indicates that an entity transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer **significant** in relation to the total variability in the present value of the future net cash flows associated with the financial asset. IAS 39 does not provide any guidance as to what is meant by significant when comparing the exposure to the variability before and after the transfer; therefore judgement is needed to assess what is significant on the basis of the specific facts and circumstances.

26. When analyzing whether risks and rewards are retained or not, IAS 39 envisages different ways of conducting such analysis, even if a legal transfer of the rights to the cash flows has occurred. IAS 39 paragraph AG51 provides examples of situations where risks and rewards are retained such as: forward contracts, put or call options, total return swaps, interest rate swaps in some limited cases, guarantees… Of course, not all exchanges will preclude de-recognition. Substance over form should be carefully assessed in every case.

View 1: outcome will depend on the analysis instrument by instrument

27. When assessing the variability in cash flows before and after the exchange, changes in the bonds characteristics (i.e. maturities, interest rates…) should be further analysed in order to determine whether a significant change in the exposure to variability has occurred. When such analysis is not conclusive, an entity should further look whether it retained control of the financial asset or not, as required by IAS 39 paragraph 20 (c). The outcome of such analysis might be different when performing the case on an instrument by instrument basis, because of the different characteristics of the original assets to be exchanged.

28. Some argue that when conducting such analysis, the fact that the cash flows of the new instruments are 53.5% lower due to the loss incurred should be taken into account and this is indicative for proving that significant changes have occurred. Others consider that this argument cannot be used because it has been assumed that partial derecognition is applicable in accordance with IAS 39 paragraph 16 and therefore each element of the transaction should be analysed independently.

View 2: entity has not transferred substantially all the risks and rewards

29. IAS 39 paragraph AG51 does not include explicitly an exchange of bonds as the paragraph does not try to include all types of ways of retaining risks and rewards. Since it refers to synthetic arrangements such as total return swaps which do not lead to de-recognition, it could be presumed that an actual bond swap would be treated similarly. This is an example in which a financial asset is transferred but simultaneously a total return swap is entered into. A total return swap can be considered in substance as being just a "synthetic" asset, therefore if a synthetic asset is enough to preclude de-recognition, a "pure" or "real" asset received in exchange should preclude derecognition as well.

30. In the case of the exchange of the old Greek bonds for new Greek bonds with fixed interest rates and maturities of 11 to 30 years, the bondholder is still substantially exposed to the same risks and rewards, being mainly:

(a) similar credit risk related to exposure to the same counterparty Greek Government

(b) significant liquidity risk and

(c) similar market risk due to the long maturity of some of the new bonds with fixed interest rates.

On the basis of the elements included above, at least continuing involvement should be assessed and therefore the original asset is **not derecognized, but treated as a modification**.

D.2. Approach B

31. If it is considered that the exchange is not in the scope of IAS 39, a bondholder will apply IAS 8 paragraphs 10 to 12. These require management to use its judgement in developing and applying an accounting policy that results in information that is reliable and relevant to the economic decision making needs. In making this judgement, two views have been identified.

View 1: An entity will choose to apply analogy with financial liabilities de-recognition criteria

32. In applying IAS 8, an entity might find relevant to apply IAS 39 paragraph 40 provisions for financial liabilities. IAS 39 paragraph 40 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 recognition of a new financial liability. Paragraph AG62 provides further detail on the way this should be evaluated, including a quantitative (10%) test.

33. In the case of the Greek exchange, the results of the quantitative test will depend on the characteristics of the portfolio of the old bonds. Among other elements, an entity will have to assess whether modifications of the maturity (new bonds mature between 11 and 30 years whereas previous bonds mature between 1 month to 15 years) and interest rates are considered significant.

34. The outcome might be different, either **de-recognition of asset or modification**, based on the analysis on an instrument by instrument basis.

35. There is some criticism against this view because de-recognition rules for financial assets and liabilities are based on different principles. Impairment rules exist for financial assets in order to reflect losses, while there is no equivalent on the financial liability side. Therefore, an analogy with financial liabilities should not be applied, as principles, objectives and underlying "philosophies" are different.

View 2: An entity will chose to look further to other guidance

36. In this view it is considered that IAS 39 does not provide sufficient elements to conclude on the accounting treatment, and an entity will apply IAS 8 paragraph 11 or 12 and use its judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision making needs and reliable.

37. In doing so, IAS 8 paragraph11 and 12 consider the following sources:

    (a) Requirements in IFRSs dealing with similar and related issues,

    (b) The Framework,

    (c) "Most recent pronouncements of another standard-setting body that uses a similar conceptual framework"

38. ESMA has not carried out further analysis in this respect.

E. Other matters to be analysed in relation to the exchange

39. This section deals with other specific matters identified as part of the analysis of the exchange.

Question 4: What is the accounting treatment if the bonds are not derecognised?

40. Two views seem possible regarding the accounting treatment in case the analysis concludes not to derecognise the bonds:

(a) Apply IAS 39 paragraph AG62: a modification of a liability has no profit and loss impact and the effect is dealt with through a modification of the effective interest rate and no profit and loss impact is accounted. The rationale for this view is to apply the analogy with a modification of a liability in full.

(b) Apply IAS 39 paragraph AG8: the carrying amount of the asset is recalculated by "computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss".

41. Whether (a) or (b) is applied would seem to depend on whether IAS 39 paragraph 17 or IAS 39 paragraph 40 has been applied.

42. In the case that the former bonds were classified as loans and receivables and the exchange is considered to be a modification, there is a question whether the bonds can continue to be classified as loans and receivables if the market of the new bonds is active,. The standard is silent on this point, leaving some to argue the bonds can still be loans and receivables, even if there is an active market.

Question 5: What is the accounting treatment of the new bonds in case there is derecognition?

43. IAS 39 paragraph AG 5 states that "in some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate". The question arises whether it is possible to apply this paragraph for the new Greek bonds. If so, in practice the effective interest rate will be lower than the effective interest rate computed without using AG5.

Question 6: What is the accounting treatment of the GDP linked securities?

44. IAS 39 does not define the meaning of a non-financial variable specific to a contract's party and does not indicate the accounting treatment for such instrument. Different views seem to exist with respect to the accounting treatment of the GDP linked securities.

45. In this case, the instrument is considered not being a derivative as the variable is a non-financial variable specific to a party to the contract (IAS 39 paragraph 9). The following options have been identified:

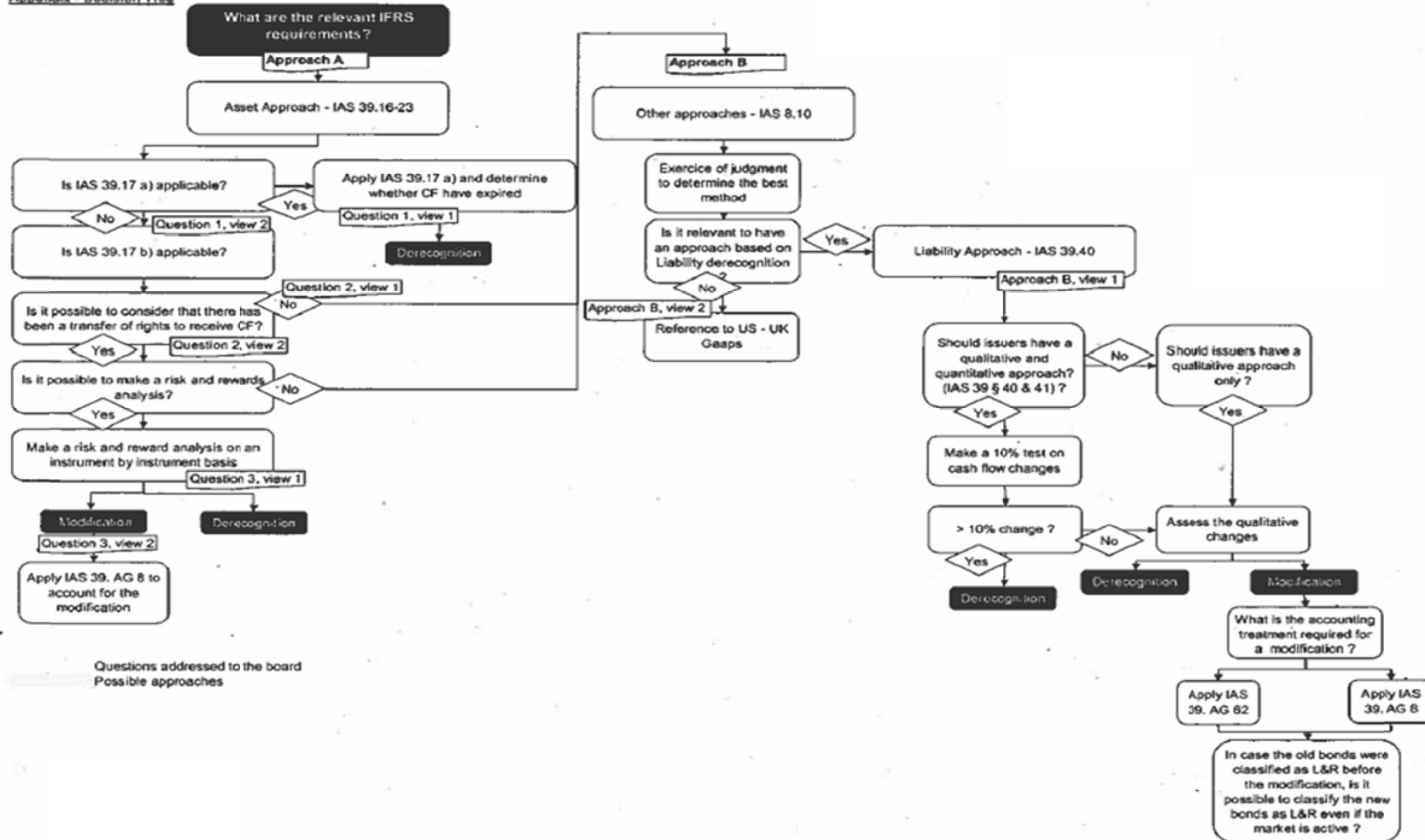
(a) The instrument is close to a derivative and it should be accounted at fair value through profit or loss;

(b) The instrument should be accounted at amortised cost and apply IAS 39 paragraph AG8 to account for the modification of cash-flows;

(c) The instrument should be classified as available for sale,

(d) The instrument is not in the scope of IAS 39 and the entity will apply IAS 18 - *Revenue* to recognise revenues from the instrument and IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* to account for an accrual if needed.

Appendix - Decision Tree



Appendix C–Draft agenda decision

The staff reproduces the Interpretations Committee Update posted on the web. All information has been copied without modification and is shown below.

IAS 39 Financial Instruments: Recognition and Measurement—Accounting for different aspects of restructuring Greek Government Bonds

C1. The Committee received a request for guidance on the circumstances in which the restructuring of Greek government bonds (GGB) should result in derecognition of the whole asset, or only part of it, in accordance with IAS 39. In particular, the Committee has been requested to consider the following questions:

- Whether the portion of the old GGBs that are exchanged for twenty new bonds with different maturities and interest rates should be derecognised, or conversely accounted for as a modification or transfer that would not require derecognition?
- Whether IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be applicable in analysing the submitted fact pattern?
- Whether either paragraphs AG8 or AG62 of IAS 39 would be applicable to the fact pattern submitted if the GGBs were not derecognised?
- What is the appropriate accounting for the GDP-linked security that was offered as part of the restructuring of GGBs?

Exchange of financial instruments: derecognition?

C2. The Committee noted that the request has been made within the context of a narrow fact pattern. The narrow fact pattern highlights the diversity in views that has arisen in relation to the accounting for the portion of the old GGBs that is exchanged for twenty new bonds with different maturities and interest rates. The submitter asked the Committee to consider whether these should be derecognised, or conversely accounted for as a modification or transfer that would not require derecognition?

C3. In addition, the Committee has been asked to consider whether IAS 8 would be applicable in analysing the submitted fact pattern, and whether the exchange can be considered a transfer within the scope of paragraph 17(b) of IAS 39.

C4. The Committee observed that the term ‘transfer’ is not defined in IAS 39. However, the potentially relevant portion of paragraph 18 of IAS 39 states that an entity transfers a financial asset if it transfers the contractual rights to receive the cash flows of the financial asset. The Committee noted that in the fact pattern submitted, the bonds are transferred back to the issuer rather than a third party. Accordingly, the Committee believed that the transaction should be assessed against paragraph 17(a) of IAS 39.

C5. In applying paragraph 17(a) of IAS 39, the 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. The 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 dealing with similar and related issues. The Committee noted that in the fact pattern submitted, that requirement would lead to the development of an analogy to the notion of a substantial change of the terms of a financial liability in paragraph 40 of IAS 39.

C6. Paragraph 40 of IAS 39 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, 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.

C7. The Committee noted that if the guidance for financial liabilities is applied by analogy to assess whether the exchange of a portion of the old GGBs for twenty new bonds is a substantial change of the terms of the financial asset, the assessment needs to be made taking into consideration all of the changes made as part of the bond exchange.

C8. In the fact pattern submitted, the relevant facts led the Committee to conclude that, in determining whether the transaction results in the derecognition of the financial asset, both approaches (ie extinguishment under paragraph 17(a) of IAS 39 or substantial change of the terms of the asset) would result in derecognition.

C9. The Committee considered the following aspects of the fact pattern in assessing the extent of change that results from the transaction:

- A holder of a single bond has received in exchange for one portion of the old bond twenty bonds with different maturities and cash flow profiles as well as other instruments in accordance with the terms and conditions of the exchange transaction.
- All of the bondholders received the same restructuring deal irrespective of the terms and conditions of their individual holdings. This indicates that the individual instruments, terms and conditions were not taken into account. The different bonds (series) were not each modified in contemplation of their respective terms and conditions but instead replaced by a new uniform debt structure.
- The terms and conditions of the new bonds are substantially different from those of the old bonds; this includes many different aspects such as the change in governing law, the introduction of contractual collective action clauses and the introduction of a co-financing agreement that affects the rights of the new bond holders, and modifications to the amount, term and coupons.

C10. The Committee noted its analysis used as the starting point the assumption in the submission that the part of the principal amount of the old GGBs that was exchanged for new GGBs could be separately assessed for derecognition. The Committee emphasised that this assumption was more favourable for achieving partial derecognition than looking at the entirety of the old bond. Hence, its conclusion that the old GGBs should be derecognised would apply even more so when taking into account that the exchange of the old GGBs was as a matter of fact the result of a single agreement that covered all aspects and types of consideration for surrendering the old GGBs. As a consequence, the Committee noted that partial derecognition did not apply.

C11. Consequently, the Interpretations Committee [decided] not to add the issue to its agenda.

Application of paragraphs AG62 or AG8 of IAS 39 to the submitted fact pattern

C12. The Committee noted that the questions raised by the submitter assume that the old GGBs in the fact pattern would not be derecognised. In the submitted fact pattern, the Committee concluded that the old GGBs are derecognised. The Committee noted that because of its conclusion on derecognition these questions did not need to be answered.

Accounting for the GDP-linked security granted as part of the restructuring of Greek government bonds

C13. The Committee discussed the request for guidance on the appropriate accounting for the GDP-linked security that was offered as part of the restructuring of GGBs.

C14. The submitter noted that IAS 39 refers to a 'non-financial variable that is not specific to a party to the contract' but does not define the meaning of that term. The Committee noted that the four alternatives in the submitted fact pattern were based on the assumption that the indexation to the issuer's GDP is a non-financial variable specific to a party to the contract. The Committee noted that the question of what constitutes an underlying that is a non-financial variable specific to a party to the contract had been considered on several previous occasions by itself and the Board. Therefore, the Committee was concerned that it could not resolve the issue efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process and that it was not probable that it would be able to reach a consensus on the issue on a timely basis. The Committee considered that it would therefore remain an open question whether the assumption in the submission is appropriate.

C15. However, the Committee thought that it could highlight some aspects that should be considered when assessing the accounting for the GDP-linked securities. The Committee highlighted the following aspects:

- The GDP-linked security is a structured option that entitles the holder to cash payments depending on the nominal and the real GDP of the issuer exceeding particular thresholds.

- Mandatory classification as at fair value through profit or loss only applies, by definition, if the GDP-linked security *is* a derivative or is otherwise held for trading.
- The definition of loans and receivables excludes those financial assets "for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale".
- The definition of held-to-maturity investments requires that an entity has the positive intention and ability to hold that financial asset to maturity. The application guidance in IAS 39 clarifies that "the criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount".
- Unless the GDP-linked securities are classified as at fair value through profit or loss they would be classified as available-for-sale debt instruments.
- Entities should consider the operational complexities of applying the effective interest method to the GDP-linked securities owing to their complex cash flow profile.

C16. The Committee considered that no clarification of IAS 39 was required. Even if changes were required, the Committee considered that IFRS 9 already used a different classification for financial assets. The Committee further noted that the issue also relates to a current IASB project (the limited review of classification and measurement under IFRS 9). Consequently, the Committee [decided] not to add the issue to its agenda.