STAFF PAPER

April 2017

IASB Meeting

Project	**Fees included in the '10 per cent' test for the purpose of derecognition**
Paper topic	Interpretations Committee tentative decisions

CONTACT(S) Markus Hahn mhahn@ifrs.org +44 (0)20 7246 6964

Introduction and objective of the paper

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

2. The Committee discussed the matter at its May 2016 meeting (see Agenda Paper 11) and published a tentative agenda decision. The tentative agenda decision noted that when applying paragraph B3.3.6 of IFRS 9 (AG62 of IAS 39) in carrying out the '10 per cent' test, an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf.

3. At its September 2016 (see Agenda Paper 9) and November 2016 (see Agenda Paper 2) meetings, the Committee reconfirmed the technical conclusions summarised in the tentative agenda decision. Nonetheless, having considered the responses to the tentative agenda decision, the Committee decided to recommend that the International Accounting Standards Board (the Board) propose an amendment to IFRS 9 to clarify the accounting as part of the next Annual Improvements Cycle.

4. The objective of this paper is to provide the Board with background on the matter and a summary of the Committee's discussions. We are asking the Board whether it agrees with the Committee's recommendation to add this matter to the Board's next Annual Improvements Cycle.

Structure of the paper

5. The paper is organised as follows:

   (a) the submission and feedback from outreach—paragraphs 6–9;

   (b) what the requirements in IFRS 9 (IAS 39) say—paragraphs 10–13;

   (c) the Committee's conclusion on the application of IFRS 9 (IAS 39)—paragraphs 14–16;

   (d) the Interpretations Committee's decision to recommend proposing an amendment to IFRS 9—paragraphs 17–23; and

   (e) transition requirements—paragraphs 24–27.

The submission and feedback from outreach

6. The submitter asked for clarity as to which fees and costs an entity includes when applying the '10 per cent' test for the purpose of derecognition of a financial liability.

7. The submitter identified two views:

   (a) **View One**: an entity includes only fees paid to, or received from, the lender. This is because the test is intended to capture cash flows between the borrower and the lender that may be referred to as a 'fee', but are in substance indistinguishable from other contractual cash flows of the new debt instrument. Accordingly, an entity includes such fees within the contractual cash flows of the new debt instrument when determining whether the old and new debt instruments are substantially different.

(b) **View Two**: an entity includes fees paid to, or received from, the lender plus directly attributable third-party fees. This is because the terms 'costs' and 'fees' in paragraph B3.3.6 of IFRS 9 (AG62 of IAS 39) can be read as synonymous. Consequently, an entity does not distinguish between costs and fees when performing the '10 per cent' test.

8. Outreach conducted revealed that View One is the most commonly observed approach applying IAS 39. The responses also revealed, however, that there is diversity in practice.

9. Outreach indicated that the inclusion of third-party fees typically does not change the outcome of the '10 per cent' test. Nonetheless, it can in some cases.

What the requirements in IFRS 9 (IAS 39) say

10. Paragraph 3.3.2 of IFRS 9[1] 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.

11. In addition, paragraph B3.3.6 of IFRS 9[1] says that [**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

[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.

> 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, **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.

12. Proponents of View One say that the term 'costs' in paragraph B3.3.6 of IFRS 9 (AG62 of IAS 39) includes third-party costs or fees together with those costs or fees payable to the lender. The lack of any reference to 'costs' in the first sentence of paragraph B3.3.6 of IFRS 9 describing the '10 per cent' test reinforces that it is only fees paid to, or received from, the lender that an entity includes in the '10 per cent' test.

13. Proponents of View Two say that the terms 'costs' and 'fees' in paragraph B3.3.6 of IFRS 9 (AG62 of IAS 39) can be read as synonymous. They also draw an analogy to transaction costs that an entity includes in the initial carrying amount of a financial asset or financial liability. 'Transaction costs include 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' (paragraph B5.4.8 of IFRS 9). They see no reason 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.

The Committee's conclusions on the application of IFRS 9 (IAS 39)

14. The Committee noted that the objective of the '10 per cent' test is to quantitatively assess whether the new contractual terms between the borrower and the lender are substantially different from the old contractual terms between those parties. The test does this by measuring the effect of the changes in the contractual cash flows. In order to meet this objective, the Committee concluded

that an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf. Including cash flows paid or received by parties other than the entity or the lender would go beyond assessing the change in the contractual terms between the borrower and the lender.

15. Consistently with this view, the Committee observed that paragraph B3.3.6 of IFRS 9 (AG62 of IAS 39) requires 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. Paragraph B3.3.6 also includes requirements regarding how to account for 'any costs or fees incurred' relating to the exchange or modification, which depends on whether that exchange or modification results in the derecognition of the financial liability.

16. The Committee also observed that in considering the items to include in the calculation of 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 the 'fees and points paid or received between the parties to the contract' included in the calculation of the effective interest rate. In contrast, 'any costs and fees' incurred relating to an exchange or modification have a similar nature to 'transaction costs' in that they are incremental costs directly attributable to the exchange or modification.

The Committee's decision to recommend proposing an amendment to IFRS 9

17. At its May 2016 meeting, the Committee decided to publish a tentative agenda decision reflecting the observations and conclusions outlined in paragraphs 14–16 of this paper.

18. The Committee discussed the comments received in September and November 2016. Respondents to the tentative agenda decision agreed with the Committee's technical conclusions. However, some respondents suggested that the matter

would be better addressed either as a narrow-scope amendment or an Interpretation.

19. After assessing the matter against the criteria for an Annual Improvement, the Committee decided that an Annual Improvement would provide the greatest clarity on the matter. This is because, in its view, the existing requirements are not sufficiently clear to result in all stakeholders reading those requirements in the same way. The Committee therefore recommended that the Board propose an amendment to clarify the requirements in paragraph B3.3.6 of IFRS 9 as part of the next Annual Improvements Cycle—that amendment would clarify that, when carrying out the '10 per cent' test, an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf.

Should the same amendment also be made to paragraph AG62 of IAS 39?

20. If the Board decides to propose an amendment to paragraph B3.3.6 of IFRS 9 as part of the next Annual Improvements Cycle, if finalised, we would expect to issue the amendment in the second half of 2018. Accordingly, we would expect an effective date of 1 January 2020 for the amendment. This effective date would be later than the effective date of IFRS 9 (ie 1 January 2018). Consequently, we recommend not proposing an amendment to paragraph AG62 of IAS 39.

21. We note that if an entity's predominant activity is issuing contracts within the scope of IFRS 4 *Insurance Contracts* and it has not previously applied any version of IFRS 9, the entity is permitted to apply IAS 39, rather than IFRS 9, for annual periods beginning before 1 January 2021. This means that eligible entities could choose to apply IAS 39 until a date between 31 December 2020 and 30 December 2021, depending on their reporting date.

22. If the Board agrees with our recommendation regarding transition (see paragraphs 24–27 of this paper), this would mean that any amendment to paragraph AG62 of IAS 39 would apply only to modifications or exchanges of financial liabilities:

    (a) that occur between 1 January 2020 and a date between 31 December 2020 and 30 December 2021 (depending on the entity's reporting date);

(b) for insurance entities eligible to choose to continue to apply IAS 39, and have chosen to do so; and

(c) that have previously included third-party fees in the '10 per cent' test (ie not the predominant treatment observed in practice).

23. We think the cost of proposing such an amendment to IAS 39 would outweigh any potential benefit. In addition, outreach indicated that the predominant accounting treatment applying IAS 39 is consistent with the Committee's technical conclusions—ie any amendment to IFRS 9 would be clarifying in nature. Accordingly, insurance entities that choose to continue to apply IAS 39 would be able to apply the accounting treatment clarified in the amendment to IFRS 9, without a change being made to IAS 39.

Transition requirements

24. The amendment to IFRS 9, if finalised, would be narrow in scope and is unlikely to affect many entities. This is because, as outlined in paragraphs 8–9 of this paper, View One is the most commonly observed approach applying IAS 39 and the inclusion of third-party fees is often not expected to change the outcome of the '10 per cent' test. Consequently, some might suggest there is little need for any specific transition requirements—an entity should apply the amendment retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

25. However, if an entity had previously included third-party fees in the '10 per cent' test, then applying the amendment retrospectively could be burdensome. Such an entity would need to reassess each historical modification or exchange of financial liabilities that could potentially have an effect on the financial statements from the beginning of the earliest comparative period when first applying the amendment. In reassessing historical modifications and exchanges, the entity would need to reperform the '10 per cent' test excluding third-party fees to ascertain whether that would have affected the derecognition decision made. If so, the entity would then determine whether the change in accounting would have a material effect on

its financial statements. Those historical transactions may have occurred some considerable time ago.

26. We think that the benefits of retrospective application of the amendment would not outweigh the potential costs. Modifications or exchanges of financial liabilities are generally one-off transactions, rather than recurring in nature. Consequently, we think the benefits of having restated comparatives prepared on a consistent basis are less than in other situations.

27. On the basis of these factors, if the Board decides to propose an amendment to IFRS 9, we recommend prospective application of that amendment, ie an entity would apply the amendment to modifications or exchanges of financial liabilities that occur from the beginning of the annual reporting period in which the entity first applies the amendment.

Questions for the Board

1. Does the Board agree with the Committee's recommendation to propose as part of the next Annual Improvements Cycle an amendment to clarify the requirements in the first sentence of paragraph B3.3.6 of IFRS 9? That amendment would clarify that, when carrying out the '10 per cent' test, an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf.

2. Does the Board agree with the staff recommendation not to propose an amendment to IAS 39?

3. Does the Board agree to propose prospective application of the proposed amendment to modifications or exchanges that occur on or after the beginning of the annual reporting period in which the entity first applies the amendment?