European Securities and Markets Authority

THE CHAIR

Date: 22 May 2017
ESMA32-61-166

Sue Lloyd
IFRS Interpretations Committee
30 Cannon Street
London
EC4M 6XH
United Kingdom

Ref: The IFRS Interpretations Committee's tentative agenda decision on IFRS 9 - Modifications or exchanges of financial liabilities that do not result in derecognition

Dear Mrs Lloyd,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to respond to the IFRS Interpretations Committee's (IFRS IC) publication in the March 2017 IFRIC Update of the tentative agenda decision related to the application of IFRS 9 *Financial Instruments.* We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRSs.

ESMA has considered the IFRS IC's tentative decision not to add to its standard-setting agenda request the issue regarding the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. ESMA notes that the IFRS IC concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for such modifications and exchanges.

ESMA agrees that IFRS 9 provides clear guidance related to the mechanics of the application of the amortised cost method when accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition. However, ESMA would like to express its concerns about the lack of appropriate guidance related to the question **when** modification or exchange of a financial liability results in its derecognition.

In particular, ESMA highlights the lack of guidance on how to apply the qualitative test when assessing whether the terms of the two liabilities are substantially different. Furthermore, ESMA would like to point to possible structuring opportunities that the lack of guidance could further aggravate. Finally, ESMA provides suggestions on the communication of the requirements related to derecognition of the financial liabilities as part of the implementation of IFRS 9. All these comments and concerns are further detailed in the Annex to this letter.

Therefore, in order to promote consistent application of IFRS and to set standards that are enforceable, ESMA urges the IFRS IC to provide additional guidance in the wording of the agenda decision. Furthermore, we urge the IFRS IC to recommend to the Board either to reconsider its previous decision and to add the distinction between modification and derecognition of financial instruments to its active research agenda in the medium term, or to add this issue to the future post-implementation review of IFRS 9.

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

Yours sincerely,

Steven Maijoor

Cc: Hans Hoogervorst, Chairman, International Accounting Standards Board

Annex: ESMA concerns related to the tentative agenda decision

Guidance related to when modification or exchange of a financial liability results in its derecognition

1. While providing clarity to the mechanics of the application of the amortised cost method, the tentative agenda decision does not provide any additional guidance when a modification or exchange of financial liability results in its derecognition. This points to a more general issue, highlighted and reiterated by ESMA on several occasions[1] that neither requirements of IAS 39 *Financial Instruments: Recognition and Measurement* nor IFRS 9 do provide sufficient guidance to distinguish when a modification of a financial instrument results in its derecognition. ESMA regrets that this issue was not added to the active research agenda of the Board in the medium term as there is currently an uncertainty on under which circumstances modification of a financial instrument results in its de-recognition.

2. While limiting our comments in this letter to the accounting for modification or exchange of financial liabilities, we are of the view that the IFRS IC could provide additional guidance in this area. Although ESMA understands that the issue is complex and may be too broad to be resolved through an interpretation or agenda decision in its entirety, we consider that additional guidance on when modification or exchange of a financial liability results in its de-recognition is necessary in order to avoid diversity in accounting for this type of transactions, notably taking into account the current interest rate environment.

3. In particular, ESMA believes that the IFRS IC could:

   a) confirm and reiterate in the final agenda decision that the assessment of substantially different terms of the original and the modified/exchange instrument in paragraph 3.3.2 of IFRS 9 should be subject of both qualitative and quantitative test. That might entail a specific statement that although the difference in discounted present values of the instrument calculated according to paragraph B3.3.6 of IFRS 9 is below 10%, it might result in de-recognition if the terms of the instruments substantially differ from a qualitative perspective.

   b) Clarify in the agenda decision how to apply the qualitative assessment of substantially different terms in paragraph 3.3.2 of IFRS 9 by providing examples of terms to be assessed (such as change of governing law, amount, purpose of lending, term, maturity, covenants, collateral, guarantees etc.), similarly to the analysis made by the IFRS IC in its September 2012 agenda decision related to *Derecognition of financial instruments upon modification* (applied to the analysis of Greek Government Bonds).

---

[1] E.g. Letter to the IFRS IC: The IFRS IC's tentative agenda decision on IAS 39 Financial Instruments: Recognition and Measurement – Holder's accounting for exchange of equity instruments, ESMA, October 2014, ESMA/2014/1211; Letter to the IFRS IC: Accounting exposure to Greek sovereign debt, ESMA, April 2012, ESMA/2012/248; Letter to the IASB: ESMA response to the IASB's Request for Views: 2015 Agenda Consultation, December 2015, ESMA, ESMA/2015/1740

Possible structuring opportunities

4. ESMA notes that the application of IFRS 9 requirements, as confirmed by the tentative agenda decision, can lead to the opportunities for structuring transactions due to the difference in the accounting outcomes between: (i) accounting for full derecognition; and (ii) accounting for a modification not resulting in derecognition as predominantly applied under IAS 39. Such transactions are common in the current low interest rate environment, when issuers might want to modify their liabilities by extending their maturities in order to lock-in the lower interest rates for a longer period. We note that the existence of these structuring opportunities[2] put additional pressure on including in IFRS 9 robust guidance related to when modification or exchange of a financial liability results in its derecognition in order to ensure consistent application of the derecognition guidance.

5. Simplified example below points to the different accounting outcomes described above:

Original instrument:	**New Instrument:**
Nominal: 100	Nominal value: 110 (fair value at the date of transaction)
Remaining maturity: 2 years	
Fair value: 110	Maturity: 10 years
Coupon 6%	Coupon: 3.6%
NPV at original EIR[3]/carrying amount: 100	NPV at original EIR: 90.6

Accounting impact	Full de-recognition	No de-recognition (IFRS 9 approach[4])	No de-recognition (predominantly observed approach under IAS 39[5])
Modification gain/loss	Loss (10)	Gain 9.4	N/a
Interest expense recognised for the new bond (annually)[6]	(4)	(5.9)	(5)

6. Using this example, the IFRS 9 accounting treatment when the modification or exchange of the financial liability does not result in its derecognition would lead to recognition of a gain of CU[7] 9.4 at the date of transaction, even though the fair value of the instrument being exchanged was CU 110. This means that there is a transfer of economic benefits to holders of the instrument in the amount CU 10 higher than the amortised cost of the original instrument. The loss of CU 10 would have been recognised at the date of the transaction if the liability was derecognised. The gain of CU 9.4 will be reversed over time, in the interest expense (original EIR) over the 10-year period. Consequently, total discount of CU 19.4 will be recognised over time in the higher than market EIR (CU 9.4 of the modification gain and CU 10 the difference between the fair value of the liability and its previous book value).

[2] ESMA notes that different structuring opportunities exist also in the high interest environment for the financial liabilities
[3] Effective interest rate
[4] As discussed by the IFRS IC leading to the tentative agenda decision
[5] The predominant approach under IAS 39 was to spread the modification gain/loss by adjusting the EIR. This is the approach under IAS 39 that was supported by the accounting literature (either as the appropriate accounting treatment or one of the treatments acceptable under IAS 39). Such treatment could be permissible given no guidance on objective of amortised cost calculation and modification of financial assets under IAS 39, which were introduced only by IFRS 9.
[6] Linear amount used as an approximation
[7] Currency Unit

Communication of the change

7. ESMA notes that no specific transition requirements between IAS 39 and IFRS 9 have been considered for this type of transactions. Therefore, ESMA welcomes that the wording of the tentative agenda decision reminds the general IFRS 9 transition requirements, which require retrospective application subject to impracticability test in Section 7.2 of IFRS 9.

8. Furthermore, we also note that this issue has not featured prominently as an important consideration for the IFRS 9 implementation. At this stage, we fear that agenda decision alone might not be a sufficient tool for explaining such a change in practice and a more substantive communication strategy might need to be employed by the IASB. Therefore, we welcome that the IASB plans to highlight the issue. ESMA notes that any communication should also explain reasons for the clarification of the accounting guidance from IAS 39 to IFRS 9 and the appropriate accounting treatment on transition in line with IFRS 9 transition requirements. The IASB should also acknowledge that under IAS 39 different accounting practices developed **given that the guidance was not explicit** on this issue, as documented by the predominant approach developed under IAS 39 and existing accounting literature. Moreover, ESMA encourages the IASB to make a widespread publicity around this agenda decision during its participation to conferences, meeting and other public events that can place sufficient prominence to the explanation of the IFRS 9 requirements in this area.

9. Taking into account this late development, ESMA highlights the need to evaluate the effects of the guidance on modification of financial liabilities, maybe through specific question within the post-implementation review of IFRS 9 in addition to the improvement of the existing guidance on the issue suggested above.