IFRS 9: Modifications or Exchanges of Financial Liabilities that do not Result in Derecognition

Extract, IFRS Discussion Group Report on the Meeting – May 30, 2017

The IFRS Interpretations Committee was asked to clarify the requirements in IFRS 9 *Financial Instruments* relating to the modifications or exchanges of financial liabilities. Specifically, the issue is whether an entity recognizes, in profit or loss, the adjustment to the amortized cost of the financial liability when such modification or exchange does not result in the derecognition of the instrument.

In its March 2017 IFRIC Update, the IFRS Interpretations Committee issued a tentative agenda decision[1] concluding "that an entity applies paragraph B5.4.6 of IFRS 9 to all revisions of estimated payments and receipts, including changes in cash flows arising from modifications or exchanges of financial liabilities that do not result in derecognition of the financial liability. In doing so, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange." This conclusion is consistent with the requirements in paragraph 5.4.3 of IFRS 9 on the accounting for modifications of financial assets, which is new wording introduced in the financial instruments standard.

The Group members discussed the following fact pattern, taking into consideration the IFRS Interpretations Committee's tentative agenda decision.

Fact Pattern

On January 1, 2010, Entity A:

- borrowed $1 million at a fixed rate of 9 per cent per annum for 10 years, interest payable annually in arrears;
- incurred issuance costs of $100,000; and
- accounts for the loan liability using the amortized cost method.

On January 1, 2016, Entity A agreed with the lender to modify the terms of the loan as follows:

- interest rate reduced to 7.5 per cent;
- maturity of the loan extended by two years to December 31, 2021; and
- no fees were involved for renegotiating the loan.

[1] Subsequent to the meeting, the IFRS Interpretations Committee decided to refer the matter to the IASB in light of the comments received (June 2017 IFRIC Update).

The amortized cost of the loan liability at the date of modification is $947,674 and the present value of the modified loan cash flows discounted using the original effective interest rate is $864,417. The difference between the two amounts is $83,257.

The modification is not considered to be an extinguishment because the discounted present value of the cash flows under the new terms is less than 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. There are no other factors that lead to the conclusion that the modification should be treated as an extinguishment. Entity A's date of initial application of IFRS 9 is January 1, 2018 (i.e., Entity A has not early adopted IFRS 9).

Analysis: Accounting for the difference between the amortized cost of the original loan and the present value of the modified loan at the date of modification under IAS 39 and IFRS 9.

In practice under IAS 39, the amount of $83,257 would be recognized in profit or loss in future periods using the revised effective interest rate. The carrying amount of the loan liability at January 1, 2016 would not have changed (i.e., remains at $947,674).

However, based on the IFRS Interpretations Committee's tentative agenda decision in the March 2017 IFRIC Update, under IFRS 9, the amount of $83,257 would be recognized in profit or loss at the date of modification. The amortized cost of the modified loan liability at January 1, 2016 is $864,417.

Upon transition to IFRS 9, Entity A is required to retrospectively apply paragraph B5.4.6 of IFRS 9 to the modified loan that is outstanding as of the date of initial application. Entity A would need to determine the transitional adjustment required to adjust the financial liability to what the carrying value would have been if the carrying amount was changed to $864,417 and the original effective interest rate of 10.6749 per cent was applied from January 1, 2016 onwards. The transitional adjustment is recorded either to opening retained earnings of the reporting period that contains the date of initial application or the opening date of the comparative period if Entity A elects to restate the prior period figures upon adoption of IFRS 9.

The Group's Discussion

One Group member observed that modifications to liabilities that do not result in derecognition are commonly seen in practice, both for basic lending arrangements and convertible instruments. Group members agreed that the requirement under IFRS 9 to recognize the difference between the amortized cost for the original loan and the present value of the modified loan in profit or loss at the date of modification will result in a change in practice from IAS 39.

Another Group member observed that the IFRS 9 treatment will result in symmetry between the borrower and the lender, because the lender would also recognize the change in amortized cost in profit or loss at the modification date.

A few Group members expressed concern that a structuring opportunity arises under IFRS 9 as a result of the accounting treatment for modifications of liabilities that do not result in derecognition. Specifically, while a change in the interest rate would result in an amount recognized in profit or loss at the date of modification, fees paid by a borrower to a lender would result in adjustment to the

Source: www.frascanada.ca/archive-meeting-reports carrying amount of the liability. One Group member questioned whether action is required to address this issue given the accounting outcome under IFRS 9 will be different for two transactions for which the substance is the same.

The Canadian member of the IFRS Interpretations Committee provided insight on the Committee's discussion of this issue, noting in particular that this structuring opportunity was specifically acknowledged and discussed by the Committee and the IASB. The IASB decided not to address this structuring issue on the basis that they wanted to provide a stable platform to stakeholders during the implementation of IFRS 9.

The Group's discussion raises awareness about this item. The AcSB Chair and staff noted that the AcSB will be undertaking additional activities, including highlighting this issue in its IFRS webinar and a few presentations, to raise further awareness amongst Canadian stakeholders of this change. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).