IFRS 9: Accounting for Debt Modifications – Helpful Reminders

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Background

Recent decreases in the Bank of Canada interest rates and corporate borrowing rates have incentivized some entities to renegotiate their debt agreements. Given the accounting for debt modifications remains a complex area, the discussion that follows highlights some helpful reminders for a borrower to consider when accounting for debt modifications in accordance with IFRS 9 *Financial Instruments*.

Paragraph 3.3.1 of IFRS 9 states that:

> An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished — ie when the obligation specified in the contract is discharged or cancelled or expires.

Paragraph 3.3.2 of IFRS 9 further notes 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 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.

As noted in paragraph B3.3.6 of IFRS 9, the terms of a debt instrument are considered to be substantially different if the discounted present value (PV) 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 (EIR), is at least 10 per cent different from the discounted PV of the remaining cash flows of the original financial liability. This is commonly referred to as the “10 per cent test”. In determining those fees paid net of fees received, a borrower includes only fees paid or received between the borrower and the lender, including fees paid or received by either the borrower or lender on the other's behalf. The test applies to both fixed-rate and variable-rate debt instruments.

When a debt instrument is extinguished due to a debt modification with substantially different terms, the carrying value of the old debt is derecognized from the balance sheet and the new debt is recorded at fair value. A gain or loss is recognized in profit or loss for the difference between the carrying value of the original liability and the consideration paid, with all costs and fees included in the calculation of the gain or loss. All associated costs and fees are expensed as incurred.

When changes to the terms of the debt instrument are determined to be a non-substantial modification, the entity recalculates the gross carrying amount of the debt as the PV of the estimated future contractual cash flows that are discounted at the original EIR, revised only for costs and fees. The modification gain or loss is recognized in profit or loss for the difference between the PV of the original and the modified cash flows discounted using the original EIR. Any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified debt using the revised EIR.[1]

Fact Pattern 1a

- An entity enters into a two-year $100,000 loan, with the principal repayable at maturity.
- Interest is eight per cent per annum, payable annually.
- The entity incurred $5,000 in legal fees and $5,000 in fees paid to the lender.
- At the end of Year 1, the terms of the loan were modified as follows:
    - the term of the loan was extended from two years to three years;
    - the interest rate was decreased from eight per cent to six per cent; and
    - the entity incurred an additional $1,000 in legal fees and $2,000 in fees paid to the lender.

Issue 1a: Fixed rate debt modification

Analysis

Step 1: Determine the original EIR

Period	Opening carrying value	Interest expense EIR (14.079%)*	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000**	12,671	(8,000)	-	94,671
Year 2	94,671	13,329	(8,000)	(100,000)	-*

*The EIR is the rate that exactly accretes the carrying value of the loan to its par value at maturity. The EIR in this case is greater than the coupon rate of eight per cent to account for the initial discount to par derived from the impact of the transaction costs.

[1] This is explained in paragraph B5.4.6 of IFRS 9, the IFRIC Update (March 2016 and June 2017) and paragraph B3.3.6A of IFRS9.

**The opening carrying value of $90,000 reflects the initial $100,000 principal less the $5,000 legal fees and the $5,000 fee paid to the lender. Per paragraph 5.1.1 of IFRS 9, entities shall measure financial liabilities at fair value plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial liability.

Step 2: Assess if the terms of the loan are substantially different

10 per cent cash flow test:

PV of debt before modification = NPV (14.079%, - $108,000) = $94,671

PV of modified debt = $2,000 + NPV (14.079%, - $6,000, - $106,000) = $88,710

Difference ($) = $94,671 - $88,710 = $5,961

Difference (%) = $5,961/$94,671 = 6.3%

The $1,000 in additional legal fees are excluded from the calculation of the PV of the modified debt because those fees are paid to a third party, and therefore excluded from the calculation (paragraph B3.3.6 of IFRS 9). The PV of the cash flows under the new terms is less than 10 per cent different from the PV of the remaining cash flows under the original terms. Therefore, the terms of the debt are not substantially different, and the debt is not extinguished.

Step 3: Revise the cash flows and calculate the modification gain or loss

Period	Opening carrying value	Interest expense EIR (14.079%)	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000	12,671	(8,000)	-	94,671
Year 2	94,671	13,329	(6,000)	-	102,000
Year 3	102,000	14,361	(6,000)	(100,000)	10,361*

*The modification of cash flows results in the need for a modification gain in order to make the ending balance nil.

Carrying value of debt immediately before the modification = $94,671

PV of future cash flows after modification = NPV (14.079%, - $6,000, - $106,000) = $86,710

Gain = $94,671 - $86,710 = $7,961 (the modification gain differs from the result of the 10 per cent test by the amount of the new lender fee)

Step 4: Adjust the carrying value of the loan for the modification gain or loss

Period	Opening carrying value	Interest expense EIR (14.079%)	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000	12,671	(8,000)	-	94,671
Year 2	86,710*	12,208	(6,000)	-	92,918
Year 3	92,918	13,082	(6,000)	(100,000)	-

*Opening carrying value in Year 2 was computed in Step 3.

Step 5: Adjust for the new fees and costs

The entity incurred $3,000 in fees ($2,000 paid to the lender and $1,000 in legal fees)

Revised opening carrying value in Year 2 = $86,710 - $3,000 = $83,710

Period	Opening carrying value	Interest expense EIR (14.079%)	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000	12,671	(8,000)	-	94,671
Year 2	83,710	11,786	(6,000)	-	89,496
Year 3	89,496	12,600	(6,000)	(100,000)	(3,904)*

*Need to revise the EIR for the impact of costs and fees so the carrying value of the loan accretes to its par value at maturity and the ending balance is nil.

Step 6: Compute the revised EIR

Period	Opening carrying value	Interest expense EIR (16.2%*)	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000	12,671	(8,000)	-	94,671
Year 2	83,710	13,536	(6,000)	-	91,246
Year 3	91,246	14,754	(6,000)	(100,000)	-*

*The EIR is the rate that exactly accretes the carrying value of the loan to its par value at maturity. For greater clarity, interest expense is calculated using the original EIR of 14.079 per cent in Year 1, and the revised EIR of 16.2 per cent is used in Years 2 and 3.

Fact Pattern 1b

- An entity enters into a two-year $100,000 loan, with the principal repayable at maturity.
- Interest is Canadian Overnight Repo Rate Average (CORRA) plus four per cent (total of eight per cent at inception), payable annually.
- CORRA resets annually at the end of each year.
- The entity incurred $5,000 in legal fees and $5,000 in fees paid to the lender.
- Fees and costs are amortized using the EIR method as opposed to the straight-line method.
- No forecast of future CORRA rate is used to establish the original EIR.
- At the end of Year 1, the terms of the loan were modified as follows:
  - the term of the loan was extended from two years to three years; and
  - no additional fees or costs were incurred.
- In addition, at the end of Year 1, the CORRA decreased to two per cent; therefore, the new variable interest rate is six per cent (two per cent CORRA + four per cent spread).

Issue 1b: Variable rate debt modification

Analysis

Step 1a: Determine the original EIR

Period	Opening carrying value	Interest expense EIR (14.079%)**	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000*	12,671	(8,000)	-	94,671
Year 2	94,671	13,329	(8,000)	(100,000)	-**

*The opening carrying value of $90,000 reflects the initial $100,000 principal less the $5,000 legal fees and the $5,000 fee paid to the lender. Per paragraph 5.1.1 of IFRS 9, entities shall measure financial liabilities at fair value plus or minus transaction costs that are directly attributable to the acquisition or issue of the financial liability.

**The EIR is the rate that exactly accretes the carrying value of the loan to its par value at maturity. The EIR in this case is greater than the coupon rate of eight per cent to account for the initial discount to par derived from the impact of the transaction costs.

Step 1b: Determine the new EIR in Year 2 given the decrease to CORRA (not part of the debt modification)

For floating-rate financial instruments, paragraph B5.4.5 of IFRS 9 requires periodic re-estimation of cash flows to reflect the movements in the market rates of interest which alters the EIR.

Period	Opening carrying value	Interest expense EIR	Interest payment	Principal repayment	Ending carrying value
Year 1	90,000	12,671	(8,000)	-	94,671
Year 2 – original EIR 14.079%	94,671	13,329	(6,000)	(100,000)	2,000

Source: www.frascanada.ca/archive-meeting-reports

Year 2 – revised EIR 11.967%*	94,671	11,329	(6,000)	(100,000)	-

*The calculation of the revised EIR ignores the change in carrying value of the debt (and the related gain or loss) associated with the original fees as the amount was immaterial. Therefore, the EIR was updated to 11.967 per cent instead of 12.079 per cent (original EIR of 14.079 per cent minus two per cent change in CORRA).

Step 2: Assess if the terms of the loan are substantially different

10 per cent cash flow test (using the latest EIR of 11.967%):

PV of debt before modification = NPV (11.967%, - $106,000) = $94,671

PV of modified debt = NPV (11.967%, - $6,000, - $106,000) = $89,912

Difference ($) = $94,671 - $89,912 = $4,759

Difference (%) = $4,759/$94,671 = 5%

The PV of the cash flows under the new terms is less than 10 per cent different from the PV of the remaining cash flows under the original terms. Therefore, the terms of the debt are not substantially different, and the debt is not extinguished.

Step 3: Revise the cash flows and calculate the modification gain or loss

Period	Opening carrying value	Interest expense EIR	Interest payment	Principal repayment	Ending carrying value
Year 1 – original EIR 14.079%	90,000	12,671	(8,000)	-	94,671
Year 2 – revised EIR 11.967%	94,671	11,329	(6,000)	-	100,000
Year 3 – revised EIR 11.967%	100,000	11,967	(6,000)	(100,000)	5,967

Carrying value of debt immediately before the modification = $94,671

PV of future cash flows after modification = NPV(11.967%, - $6,000, - $106,000) = $89,912

Modification gain = $94,671 - $89,912 = $4,759

Step 4: Adjust the carrying value of the loan for the modification gain or loss

Period	Opening carrying value	Interest expense EIR	Interest payment	Principal repayment	Ending carrying value
Year 1 – original EIR 14.079%	90,000	12,671	(8,000)	-	94,671
Year 2 – revised EIR 11.967%	89,912*	10,759	(6,000)	-	94,671
Year 3 – revised EIR 11.967%	94,671	11,329	(6,000)	(100,000)	-

*Opening carrying value in Year 2 was computed in Step 3.

If the modification had instead included new incremental costs or fees, it would require a further revision to the EIR once the costs or fees are booked. The approach would be the same as the example in Issue 1a on the fixed rate debt modification.

The Group's Discussion

The Group agreed with the analysis. Some Group members emphasized the importance of evaluating all relevant terms and conditions in loan arrangements when determining whether to apply the non-substantial debt modification or extinguishment guidance in IFRS 9. One Group member raised an example that was highlighted in a 2018 IDG discussion on modifications or exchanges of fixed-rate and floating-rate financial instruments. As part of that discussion, the Group discussed the accounting for the modification of a floating-rate loan with a prepayment option and no early prepayment penalty. The discussion highlighted that, depending on the facts and circumstances, the modification of the loan could be accounted for as a non-substantial modification or an extinguishment. Alternatively, an entity might conclude that the loan itself should be accounted for as a variable-rate loan.

One Group member noted that IFRS 9 does not provide specific guidance on calculating the EIR for variable-rate debt, resulting in diversity in how it is calculated. In practice, some entities use the actual benchmark rate at loan inception, while others incorporate forecast rates for future periods. Another member emphasized the requirement to recalculate the EIR for variable-rate loans when the benchmark rate changes before applying the 10 per cent test.

One Group member observed that a payment stated in an agreement between a borrower and a lender that is labelled as a “fee” should not automatically be accounted for as a “fee” under paragraph B3.3.6A of IFRS 9. They emphasized the importance of considering the substance of such payments. For example, for a modification that is not an extinguishment, if in substance, the fee payable to the lender relates to the provision of services to modify the debt but exceeds the fair value of such services, the excess amount would not adjust the carrying amount of the debt. Instead it would be treated as a cash flow of the modified debt and therefore it would be included in the calculation of the modification gain or loss.

One Group member noted that when a debt modification is treated as an extinguishment, costs or fees incurred may be attributed to the new debt in rare circumstances and amortized over its term as part of the effective interest rate instead of being expensed immediately. However, this would require clear evidence that the costs are solely attributable to the new debt.

Issue 2: Qualitative factors

In certain situations, the terms of a loan might have substantially changed even if the net PV of the cash flows under the new terms differs by less than 10 per cent from the PV of the original debt instrument’s remaining cash flows. In such situations, the entity would apply paragraph 3.3.2 of IFRS 9 and extinguish the original loan and recognize a new loan. A qualitative assessment can help identify substantial changes in terms that may not be captured by the quantitative assessment. This requires judgment based on the specific facts and circumstances.

Qualitative factors to consider include, but are not limited to, the following:

- a change in the currency in which the liability is denominated;
- a change in the interest rate basis (e.g., converting from a fixed to a floating or vice versa);
- a significant extension of the debt’s term;
- substantial changes in debt covenants; and
- the introduction or removal of a conversion feature.

The Group's Discussion

The Group agreed with the analysis of qualitative factors an entity might consider when assessing whether the terms of a loan have substantially changed. Group members highlighted additional factors that could indicate a loan has been extinguished. For example:

- a modification occurring close to the loan's maturity date;
- changes in recourse or non-recourse features;
- changes in the loan's priority level; and
- adjustments to the requirement for or type of collateral.

Some Group members noted that in some circumstances qualitative factors might be assessed before or alongside the 10 per cent test and could lead to a conclusion of substantial modification regardless of the outcome of the 10 per cent test.

One Group member also thought that entities should consider how substantial changes to loan terms might affect the application of other accounting standards. For example, an entity might consider the impact on financial instrument disclosures, interest capitalization policies, or the functional currency assessment in the case of a change in the currency of an entity's primary source of financing.

Issue 3: Modification of revolving credit facilities

Revolving credit facilities or lines of credit often have balances that fluctuate as entities borrow and repay amounts. In some circumstances it can be unclear if or how the derecognition requirements in IFRS 9 apply to loan commitments. If no IFRS Accounting Standard specifically applies to the modification of a revolving credit facility, an entity must apply judgment in developing and applying an accounting policy that results in information that is relevant and reliable. In developing an accounting policy that complies with the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the entity should consider the applicability of requirements in IFRS Accounting Standards dealing with similar and related issues, as well as the concepts in the *Conceptual Framework for Financial Reporting*. The entity may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards. Two possible approaches include:

- apply the 10 per cent test and, if applicable, qualitative assessment; or
- apply the applicable requirements in U.S. generally accepted accounting principles (GAAP) (i.e., Accounting Standards Codification® (ASC) 470-50-40-21 *Modifications and Exchanges of Line-of-credit or Revolving Debt Arrangements*) by analogy.

ASC 470-50-40-21 applies only to modifications or exchanges of revolving credit arrangements when the parties in the arrangement remain the same. Consistent with IFRS 9, under U.S. GAAP a change in creditor would be considered a substantial change and accounted for as an extinguishment.

For a modification or exchange that results in an increase in an entity’s borrowing capacity (i.e., remaining term multiplied by the maximum credit per term), ASC 470-50-40-21 requires the remaining unamortized deferred costs and any new fees and costs incurred to be deferred and amortized over the term of the new arrangement.

For a modification or exchange that results in a decrease in an entity’s borrowing capacity, the following requirements apply:

- New fees and costs incurred on the new arrangement should be deferred and amortized over the term of the new arrangement.
- Unamortized deferred costs relating to the old arrangement should be written off in proportion to the decrease in borrowing capacity of the old arrangement.
- The remaining unamortized deferred costs relating to the old arrangement should be deferred and amortized over the term of the new arrangement.

The Group’s Discussion

Since IFRS 9 does not provide guidance on the accounting for modifications to revolving credit facilities, some Group members noted that they have observed diversity in the accounting for such modifications. Some noted that they have observed the application of the U.S. GAAP requirements by analogy by entities applying the GAAP hierarchy in IAS 8. They also noted that it can be challenging to perform the 10 per cent test on a revolving credit facility since the amount of credit drawn by an entity can fluctuate over time, and there are varying interpretations as to how this test should be performed. One Group member noted that entities should apply the 10 per cent test and qualitative assessment required by IFRS 9 for modifications to drawn revolvers because drawn revolvers meet the definition of a financial liability in IFRS 9. However they noted that there is diversity in how the 10 per cent test is applied to revolvers, and that it is important for entities to establish an appropriate accounting policy.

Issue 4: Loan Syndications

In applying the debt modification requirements in IFRS 9, the borrower in a loan syndication arrangement should determine whether the arrangement represents a single loan from a single lender or multiple separate loans from each individual lender based on evaluation of the legal terms and substantive conditions of the arrangement. Factors that an entity may consider, individually or in combination, in assessing whether there is a single loan or multiple loans include the following:

- determining whether the borrower negotiates loan terms only with the lead lender or with individual lenders within the syndicate;
- determining whether the loan terms are identical or differ, depending on the lender;
- determining whether loan repayments are automatically allocated among lenders on a pro rata basis, or the borrower may be able to selectively repay amounts to specific lenders within the syndicate;

- determining whether the borrower can only renegotiate with the lead lender or may selectively renegotiate loans with individual lenders or subsets of lenders within the syndicate; and
- determining whether members of the syndicate may change without the permission of the borrower, or whether such a change may require an amendment to the loan agreement.

The Group's Discussion

The Group agreed with the analysis. One Group member emphasized the importance of examining the legal terms and substantive conditions of a contract to determine whether it represents a single loan from a single lender or multiple separate loans from each individual lender. They noted that, while an arrangement might appear to be a single loan, particularly if one lender is appointed to negotiate or administer the loan on behalf of the syndicate, a detailed review of the terms could indicate otherwise. Additionally, they raised that syndicated loans often include embedded derivatives, which should be considered when assessing whether the loan terms have been substantially modified.

Overall, the Group's discussion raised awareness of the accounting for debt modifications. No further actions were recommended to the AcSB.