IFRS 9: Modifications or Exchanges of Fixed-rate and Floating-rate Financial Instruments

Extract, IFRS® Discussion Group Report on the Meeting – June 21, 2018

At its January 2018 meeting, the Group discussed the IASB's clarification on the accounting for modifications or exchanges of financial liabilities. This clarification was included in the Basis for Conclusions on IFRS 9 *Financial Instruments* as a result of the amendments to IFRS 9 for "Prepayment Features with Negative Compensation," which were issued in October 2017. The clarification indicated that an entity applies paragraph B5.4.6 of IFRS 9 to such transactions and a gain or loss should be recognized in profit or loss at the date of the modification or exchange.

One of the issues discussed by the Group was whether the clarification would apply to a debt instrument with a lack of prepayment penalty. At that time, the Group noted that the issue was being discussed globally, with views held on both sides.

The Group continued its discussion on this topic using the following fact pattern.

Fact Pattern

- Entity A has debt with an interest rate of LIBOR + 200 with a prepayment option at par without penalty payable by Entity A or receivable by the lender.
- Entity A subsequently renegotiates the terms of the debt with the lender such that the debt now has an interest rate of LIBOR + 175, reflecting the current market rate. No other contractual terms were modified. Entity A incurred transaction costs as part of the renegotiation.
- At the time of the renegotiation, Entity A has the practical ability to refinance the debt with other lenders, without penalty.

Issue: How should Entity A account for the renegotiation of the floating-rate debt instrument?

View A – Entity A should apply the modification guidance in IFRS 9.

Under this view, in accordance with paragraph 3.3.2 of IFRS 9, Entity A would assess whether the renegotiation to the current market rate resulted in a substantial modification of the terms of the debt. The same guidance would apply to the renegotiation of a fixed-rate financial instrument.

If the modification is considered substantial, paragraph B3.3.6 of IFRS 9 would apply. The modification is accounted for as an extinguishment of the original financial liability, including any unamortized transaction costs, and a new financial liability would be recognized. In addition, the transaction costs incurred as part of the renegotiation are recognized as part of the gain or loss on extinguishment of the original debt instrument.

If the modification is not considered substantial, paragraph B5.4.6 of IFRS 9 would apply. The entity recalculates the amortized cost of the financial liability using the financial instrument's original effective interest rate to reflect the actual and revised estimated contractual cash flows. The adjustment is recognized in profit or loss as income or expense. Transaction costs incurred as part of the renegotiation are recognized as an adjustment to the carrying amount of the liability and are amortized over the remaining term of the modified liability.

View B – Entity A should apply the extinguishment guidance in IFRS 9.

Under this view, a financial instrument with the option to prepay without penalty that is renegotiated to a current market rate with the same lender has the same economic substance as an instrument for which the prepayment option is exercised, with a third-party lender issuing a new instrument at market rates.

Entity A accounts for the renegotiation as an extinguishment of the original debt, including any unamortized transaction costs, and the recognition of the new debt. In addition, the transaction costs incurred as part of the renegotiation are recognized as part of the gain or loss on extinguishment of the original debt instrument.

The Group's Discussion

In terms of how Entity A should account for the renegotiation of the floating-rate debt instrument, the presenter noted that in addition to the two views identified, another view is possible. Since the entity can prepay the debt without penalty, in substance it is like a variable-rate debt that resets to current market rates. In that case, paragraph B5.4.5 of IFRS 9 applies and there is no significant effect on the carrying amount of the liability.

One Group member noted that there has been a shift in global discussions on this issue, resulting in the acceptance of both View A and View B (i.e., apply the modification or extinguishment guidance in IFRS 9). Another Group member also noted seeing some acceptance of the view that paragraph B5.4.5 of IFRS 9 applies because if the entity can prepay the original debt and approach another lender to obtain a new debt at a lower rate, it is likely the original lender would give the lower rate to the entity. Therefore, in substance, a financial instrument with an insignificant prepayment penalty is like a variable-rate debt.

For this particular fact pattern, several Group members thought View B (i.e., apply the extinguishment guidance in IFRS 9) would produce a more reasonable accounting result. View A would produce a gain at the date of modification. However, interest expense would be higher over the remaining term of the modified liability because the adjusted carrying amount of the financial liability is amortized at the original effective interest rate. One Group member thought that since the entity has the ability to obtain financing from another lender, changing from an interest rate of LIBOR + 200 to LIBOR + 175 should reflect some degree of credit risk improvement. One Group member raised the point that from a lender's accounting perspective, deciding whether this is a new loan or the continuation of an existing loan plays an important role in the assessment of significant credit risk related to the loan asset.

The Group's discussion highlights the fact that there appears to be some acceptance of all three views in practice, depending on facts and circumstances. It is important to note that the accounting treatment of the transaction costs incurred as part of the renegotiation differs depending on which view is applied.

Overall, the Group's discussion raises awareness about developments in global discussions on this topic since the beginning of this year. The Group recommended no further action to the AcSB on the basis that it is unlikely the IASB would redeliberate this issue further at this time.

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