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

Extract, IFRS® Discussion Group Report on the Meeting – January 10, 2018

At its May 2017 meeting, the Group discussed the IFRS Interpretations Committee's tentative agenda decision relating to the accounting for modifications or exchanges of financial liabilities measured at amortized cost that do not result in derecognition. The IFRS Interpretations Committee concluded 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 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 IASB agreed with this technical conclusion. To highlight this matter, the clarification on the accounting for modifications or exchanges of financial liabilities was included in the Basis for Conclusions on IFRS 9 *Financial Instruments* in the amendments to IFRS 9 for "Prepayment Features with Negative Compensation". These amendments were issued in October 2017, and are to be applied retrospectively for fiscal years beginning on or after January 1, 2019 with early application permitted.

The Group discussed four issues to highlight when the clarification should be applied and whether it applies to the accounting for modifications of floating rate debt.

Issue 1: When should the clarification on the accounting for modifications or exchanges of financial liabilities that do not result in derecognition be applied by entities?

Analysis

The IASB's clarification was not issued as an amendment to the existing requirements of IFRS 9. Rather, it was included in the Basis for Conclusions (i.e., paragraphs BC4.252 and BC4.253) as a clarification of IFRS 9 as originally issued. Therefore, the clarification should be incorporated as part of an entity's adoption of IFRS 9 (i.e., for periods beginning on or after January 1, 2018 for most entities).

The Group's Discussion

Group members agreed with the above analysis and noted that the clarification is to be applied retrospectively. If an entity adopts IFRS 9 on a retrospective basis without restating prior period comparatives, the cumulative effect is recognized in opening retained earnings at the date of initial application.

Issue 2: Does the clarification apply to modifications of floating rate debt?

The IASB and IFRS Interpretations Committee's discussions focused on an example of a fixed interest rate debt with a fixed term. However, there was no mention of modifications of floating rate debt.

Paragraph B5.4.5 of IFRS 9 describes an effective interest rate approach when the interest rate is reset to market rates each period.

View 2A – No.

Paragraph 12 of the July 2017 IASB Staff Paper (AP3B) notes the following:

> "We note that paragraph B5.4.5 of IFRS 9 applies only to floating-rate financial instruments. When their cash flows are re-estimated to reflect movements in market rates of interest, the effective interest rate is updated. Paragraph B5.4.6 of IFRS 9, on the other hand, applies to fixed-rate instruments and will usually result in a change in the instrument's carrying amount because the revised estimated cash flows are discounted at the original EIR [Effective Interest Rate]. The adjustment is recognised in profit or loss. Accordingly, applying the requirements in IFRS 9, we think an entity cannot analogise to paragraph B5.4.5 to account for modifications or exchanges of fixed-rate instruments."

Based on the above, proponents of this view think that the clarifications do not apply to modifications of floating rate debt. According, if the conclusion was that a non-substantial modification was the result of the outcome of the "10 per cent" test, then there would be no modification gain or loss recognized.

View 2B – Yes.

Proponents of this view note that paragraph 5.4.3 of IFRS 9 is applicable to floating rate debt as there is no explicit guidance in IFRS 9. However, there are different approaches to applying the effective interest method for a floating rate instrument. Therefore, a consistent approach to dealing with modifications should be applied.

The Group's Discussion

Group members agreed that the clarification applies to floating rate debt (View 2B).

Different from View 2A, a Group member thought that paragraph B5.4.5 of IFRS 9 just explains the outcome of the amortized cost accounting approach for a pure floating rate financial instrument issued at par with no premium or discount, and no cost or fees. In such circumstances, when the rate is reset for movements in market rates, there is normally no adjustment to the instrument's carrying amount because the entity updates the effective interest rate. However, paragraph B5.4.5 of IFRS 9 implies that there could be a gain or loss adjustment if the instrument is not a pure floating rate financial instrument. The clarification requires that an entity apply amortized cost accounting when there is a modification. Applying such an accounting approach could lead to a gain or loss if there were fixed elements in the prior effective interest rate of the floating rate instrument that were caused, for example, by an original issue premium or discount, fees and costs or a fixed spread.

Issue 3: Does the clarification apply when the floating rate debt has a fixed credit spread that changes in modification?

View 3A – No

This view is similar to View 2A. Also, proponents of this view think that the clarification still does not apply because the base interest rate is floating.

View 3B – Yes

Proponents of this view think that the credit spread effectively introduces a fixed component to the otherwise floating rate. As a result, there is a possibility that there could be a modification gain or loss when the fixed credit spread changes. Depending on the magnitude of the fixed credit spread compared to the floating component, the instrument may behave more like a fixed rate instrument. The modification must be analyzed to determine if there would be a gain or loss to recognize.

The Group's Discussion

Group members agreed that the clarification also applies when the floating rate debt has a fixed credit spread (View 3B), albeit the mathematical computation would be more complex compared to the situation in Issue 2.

The entity would calculate the gain or loss on the differential between the original and new fixed credit spreads and recognize the amount in profit or loss. The result is that the entity continues to recognize the amortized cost of the floating rate debt using the original fixed credit spread (assuming no fees or costs are incurred to effect the modification).

A Group member noted that it is difficult to apply a pure effective interest rate model when the floating rate financial instrument is mixed with fixed and variable elements. In practice, entities sometimes apply a straight-line approach to the fixed element of the instrument, especially if the fixed element represents transaction costs, and use the effective interest rate method for the variable element on the basis of materiality.

Issue 4: Assuming the clarification applies when the fixed credit spread changes (View 3B), would the lack of prepayment penalty change whether the clarification still applies?

Modifications of debt instruments before maturity are often achieved by prepaying the original debt instrument and negotiating new terms. Under many debt agreements, such a prepayment often involves the borrower paying a penalty to compensate the lender for lost interest under the original terms. However, in some cases, it is possible to prepay the original debt without penalty.

Issue 3 did not include any consideration of prepayment penalties.

View 4A – Unchanged, the clarification still applies.

Similar to View 3B, there is no explicit scope exclusion for modifications of financial liabilities with floating interest rates. Therefore, the guidance should be applied, although there may be different approaches to calculating the modification gain or loss.

View 4B – Changed, the clarification would not apply.

Proponents of this view think that the clarification does not apply to situations when there is only a floating rate component to the contractual interest rate (View 2A). Given there is no prepayment penalty, the instrument is akin to one that resets periodically to market rates. The borrower can trigger the renegotiation of a new credit spread at any time without penalty. Unlike situations when a penalty must be paid to compensate the lender for a reduction in credit spread, the interest rate on this instrument is truly a floating rate regardless of the credit spread.

Proponents of this view may also think that the clarification would not apply when there is no prepayment penalty but that it does apply in cases when prepayment would involve paying a penalty to compensate the lender for lost interest. In the latter case, the fact that a penalty is paid to compensate the lender for the reduction in credit spread means that the instrument behaves more like a fixed rate instrument.

The Group's Discussion

A Group member clarified that in the situation contemplated under Issue 4, the lender is the same before and after the prepayment. A situation in which the entity prepays the original debt instrument and renegotiates a new debt instrument with a different lender is likely an extinguishment of the debt instrument, depending on facts and circumstances.

Group members observed that there are many jurisdictions with debt instruments permitting an entity to prepay without penalty. This issue is being discussed globally, with views held on both sides.

Group members thought that there is still a modification to the debt instrument in the fact pattern and supported the view that the clarification applies even in the absence of a prepayment penalty (View 4A). The rationale is that while the borrower has the right to prepay the debt instrument, the lender is not contractually obligated to fund the prepayment. Therefore, the renegotiated debt instrument is likely not pursuant to the terms and conditions of the original debt instrument. If the entity concludes that the renegotiated debt instrument is not a substantive modification, the clarification guidance would apply when accounting for the change in terms and conditions.

The Group observed that modifications or exchanges of financial liabilities are prevalent in practice and the accounting treatment can be quite complex. Overall, the Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

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