

## Debt Modification Accounting (ASPE)

---

### What you need to know (May 2020)

#### What's the issue?

1. Significant reductions in revenue and, in some cases, higher operating costs due to COVID-19 are leaving many private enterprises struggling to make payments on their loans. To keep their businesses afloat, these enterprises are working with their lenders to change terms of existing debt agreements or to obtain waivers for debt covenants. Borrowers applying Accounting Standards for Private Enterprises (ASPE) should closely examine changes to their debt agreements to assess whether they are subject to modification or extinguishment accounting, as required by Section 3856, *Financial Instruments*.

#### How should the borrower account for debt modifications?

2. A borrower's accounting depends on whether a modification is considered "substantial" or "non-substantial." If the terms of the debt agreement have substantially changed, the borrower should follow the extinguishment accounting. Alternatively, if the terms have not substantially changed, the accounting for the existing debt is amended to reflect the modified terms. ([Paragraph 3856.27](#))
3. The Appendix to Section 3856 provides guidance on assessing whether the modification is considered substantial. Often referred to as the "10 percent test," the borrower should first calculate the present value of cash flows under the new arrangement. If this present value is at least 10 percent different from the present value of the remaining cash flows of the original arrangement, the modification is substantial. ([Paragraphs 3856.A52-A53](#))

4. In addition to the 10 percent test, the borrower should apply judgment to assess whether qualitative factors indicate that a modification is substantial. Some factors to consider may include significant change in the collateral or a significant change in covenants.
5. If the modifications are substantial, the original liability is removed from the financial statements and a new liability is recorded at fair value. ([Paragraph 3856.27](#)) Any difference between the fair value of the new liability and the carrying value of the old liability is recognized as a gain or loss in net income. ([Paragraph 3856.A54](#))
6. If the modifications are non-substantial, the carrying value of the existing liability is adjusted to reflect the new terms. If there are any costs associated with the new agreement, these are added to the carrying amount of the liability and amortized over the remaining life of the debt. ([Paragraph 3856.A55](#))

#### **Assessing compliance with covenants and considerations for breach of covenants**

7. Some private enterprises may have breached their debt covenants arising from the sudden and unexpected change in market conditions due to COVID-19.
8. If a covenant has been breached, management should first review lending contracts to assess the remedies available. For example, there may be a grace period during which the covenant breach can be remedied. Management should also assess how the breach of covenants on long-term debt may affect the debt classification on the balance sheet.
9. When a debt covenant is breached, the debt must be classified as a current liability on the balance sheet unless:
  - (a) the creditor waives its right to demand repayment for more than a year from the balance sheet date; or
  - (b) the debt agreement contains a grace period to remedy the violation, and contractual arrangements are made to remedy the covenant breach during the grace period. ([Paragraph 1510.14](#))
10. These remedies could be in the form of revised covenants on the existing loan agreement or exceptions from meeting certain covenants for a period of time.
11. If a private enterprise has more than one debt facility, it should consider how a covenant violation on one debt facility affects its other debt facilities. Debt agreements often have cross-default provisions whereby a breach on one debt facility will trigger a breach on another debt facility. In these situations, the enterprise would need to remedy the breach by obtaining a waiver for all affected debt facilities, to classify the debt as non-current.
12. In some cases, a breach on debt covenants can be so significant to the borrower that it creates uncertainties about the borrower's ability to continue as a going concern. For example, if the lender calls its loan and the borrower has no alternative sources of financing, it may be forced to declare

bankruptcy. Borrowers should refer to the resource "[Going Concern and Liquidity Risk \(ASPE\)](#)" for additional details on how to assess going concern.

13. Management should also consider the extent of disclosures for covenant breaches on the financial statements. For example, if a covenant is breached due to deferred payments or financial weakness because of COVID-19, disclosure of the breach is required. Similarly, if the breach is remedied through refinancing or renewed covenants before the financial statements are completed, disclosure of the remedy is required. ([Paragraph 3856.46](#))

## Extracts from relevant ASPEs

Standard	Guidance
Section 1510	<p>.14 Long-term debt with a measurable covenant violation is classified as a current liability unless:</p> <ul style="list-style-type: none"> <li>(a) the creditor has waived, in writing, or subsequently lost, the right, arising from violation of the covenant at the balance sheet date, to demand repayment for a period of more than one year from the balance sheet date; or</li> <li>(b) the debt agreement contains a grace period during which the debtor may cure the violation and contractual arrangements have been made that ensure the violation will be cured within the grace period;</li> </ul> <p>and a violation of the debt covenant giving the creditor the right to demand repayment at a future compliance date within one year of the balance sheet date is not likely.</p>
Section 3856	<p>.27 Except as specified in paragraph 3856.27A, a transaction between a borrower and lender to replace a debt instrument with another instrument having substantially different terms is 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) is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.</p> <p>.46 For financial liabilities recognized at the balance sheet date, an enterprise shall disclose:</p> <ul style="list-style-type: none"> <li>(a) whether any financial liabilities were in default or in breach of any term or covenant during the period that would permit a lender to demand accelerated repayment; and</li> <li>(b) whether the default was remedied, or the terms of the liability were renegotiated, before the financial statements were completed.</li> </ul> <p>.A51 In order to determine whether there has been a modification or exchange of debt instruments in transactions involving a third party intermediary, it is necessary to determine whether the intermediary is acting as an agent or as a principal. If the intermediary acts on behalf of the debtor and does not place its own funds at risk, there is an agency relationship and the actions</p>

Standard	Guidance
	<p>of the intermediary are viewed as those of the debtor. However, if the intermediary commits its own funds and is subject to the risk of loss of those funds, the intermediary is acting as a principal and is viewed as a third party creditor similar to any other creditor. In order to determine whether the third party intermediary is acting as an agent or a principal, all the facts surrounding the role of the intermediary are evaluated.</p> <p>.A52 For the purpose of paragraph 3856.27, the terms of a renegotiated financial liability differ substantially from the original liability when:</p> <ul style="list-style-type: none"> <li>(a) the present value of the cash flows under the new terms, including any fees paid net of any fees received differs by at least 10 percent from the present value of the remaining cash flows of the original financial liability, both discounted at the original interest rate; or</li> <li>(b) there is a change in the creditor and the original debt is legally discharged by the debtor through a cash payment or otherwise.</li> </ul> <p>.A53 In comparing the present value of discounted cash flows in accordance with paragraph 3856.A52(a), an enterprise includes changes in principal amounts, interest rates or maturity as well as fees exchanged between the debtor and creditor to effect changes in such attributes as:</p> <ul style="list-style-type: none"> <li>(a) recourse or non-recourse features;</li> <li>(b) priority of the obligation;</li> <li>(c) collateralized (including changes in collateral) or non-collateralized features;</li> <li>(d) debt covenants or waivers;</li> <li>(e) the guarantor (or elimination of the guarantor); or</li> <li>(f) call or redemption features.</li> </ul> <p>.A54 When an exchange of debt instruments (exchange) or a modification of the terms of a financial liability (modification) issued in an arm's length transaction is accounted for as an extinguishment in accordance with paragraph 3856.26, the debtor accounts for the difference between:</p> <ul style="list-style-type: none"> <li>(a) the fair value of the new debt instrument; and</li> <li>(b) the carrying amount of the original debt instrument (together with all unamortized financing fees and transaction costs accounted for as adjustments to the original debt instrument).</li> </ul> <p>as a gain or loss in net income.</p>

<b>Standard</b>	<b>Guidance</b>
	<p>.A55      When an exchange or modification is not accounted for as an extinguishment, fees and transaction costs accounted for as adjustments to the original debt instrument continue to be recognized as a component of the carrying amount of the debt instrument and, together with fees and transaction costs related to the renegotiation, are amortized over the remaining term of the renegotiated debt (see paragraph 3856.A4)</p>