

Debt Modification Accounting

What you need to know (May 2020)

What's the issue?

1. Significant reductions in revenue and higher operating costs due to COVID-19 are leaving many companies struggling to make payments on their loans. To keep their businesses afloat, these companies are working with their lenders to change terms of existing debt agreements or to obtain waivers for debt covenants. Lenders and borrowers should closely examine changes to their debt agreements to assess whether they are subject to modification or extinguishment accounting, as required by IFRS 9 *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. ([IFRS 9.3.3.2](#))
3. IFRS 9 prescribes a quantitative test to assess whether the modification is substantial. Known as the "10 per cent test," the borrower should first use the original effective interest rate (EIR) to discount the cash flows under the new terms, including any fees paid net of any fees received. If this present value is at least 10 per cent different from the present value of the remaining cash flows of the original financial liability, the modification is substantial. ([IFRS 9.B3.3.6](#))
4. In addition to the 10 per cent test, the borrower should consider performing a qualitative test to look at other factors to assess whether a modification is substantial. Some factors to consider may include a change in the currency of the loan, a significant extension on the maturity date of the loan, or a significant change in covenants.

5. If the modifications are non-substantial, the borrower should adjust the carrying amount of the existing debt liability to reflect the revised estimated cash flow payments discounted using the original EIR. The adjustment is recognized as a modification gain or loss. Furthermore, any costs or fees incurred as part of the modification are also included in the carrying amount of the liability and are amortized over the remaining term of the modified liability. ([IFRS 9.B3.3.6](#) and [IFRS 9.B5.4.6](#))
6. If the debt-agreement terms have substantially changed, the borrower should derecognize the existing financial liability and recognize a new financial liability. The new financial liability is recognized at fair value. The difference between the carrying amount and the consideration paid is recognized in profit or loss. Any costs or fees incurred are recognized as part of the gain or loss on the extinguishment. ([IFRS 9.3.2.11](#), [IFRS 9.3.3.2-3.3.3](#), and [IFRS 9.B3.3.6](#))

How should the lender account for debt modifications?

7. IFRS 9 acknowledges that in some circumstances the modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset. However, it does not provide further guidance for when a modification of a financial asset should result in derecognition. At its [September 2012 meeting](#), the IFRS® Interpretations Committee noted that in the absence of explicit guidance on when a modification of a financial asset results in derecognition, an analogy might be made to the guidance on modifications of the financial liabilities. Therefore, the lender should apply judgment and develop an accounting policy to determine whether the 10 per cent test should be used in addition to qualitative factors to assess whether the modifications to financial assets are substantial. For a portfolio of similar loans, the lender may consider applying an accounting policy at the portfolio level. ([IFRS 9.B5.5.25](#))
8. To account for modifications to financial assets that are non-substantial, the lender should recalculate the gross carrying amount of the debt as the present value of the renegotiated contractual cash flows that are discounted using the original EIR. The adjustment to the carrying amount of the modified asset is recorded as a modification gain or loss in profit or loss. Any costs or fees incurred adjust the carrying amount of the modified debt and are amortized over the remaining term of the modified debt. ([IFRS 9.5.4.3](#)).
9. In addition to valuation of the modified debt, the lender should consider the possibility of significant increases in credit risks and the resulting impact on the measurement of expected credit losses. To assess whether a significant increase in credit risks has occurred, the lender should compare the risk of a default occurring based on the modified contractual terms with the risk of a default based on the original, unmodified contractual terms. In this assessment, the lender should consider both historical information, such as the circumstances that led to the modification and forward-looking information, such as the forecasted changes in business, financial or economic conditions. ([IFRS 9.5.5.12](#) and [IFRS 9.B5.5.27](#))
10. Similar to a borrower's accounting when the debt-agreement terms have substantially changed, the lender should derecognize the existing financial asset and recognize a new financial asset. The difference between the carrying amount (measured at the date of derecognition) and the consideration received is recognized in profit or loss. The new financial asset is recognized at fair

value plus any costs incurred that are directly attributable to the acquisition of the new debt. (IFRS [9.3.2.12](#), [IFRS 9.5.1.1](#), and [IFRS 9.B5.5.25](#)).

Additional considerations for breach of covenants

11. A borrower should assess how the breach of covenants on its long-term debt may affect the debt classification on its balance sheet. If the breach occurs on or before the reporting date and provides the lender with the right to demand repayment within 12 months of the reporting date, the debt liability should be classified as current on the borrower's balance sheet. ([IAS 1.69\(c\)](#))
12. The borrower may negotiate with the lender for a waiver to defer payments beyond 12 months from the reporting date. Such a waiver should be obtained on or before its reporting date for the debt to be classified as non-current. ([IAS 1.74](#))
13. Any breach of covenants occurred, or waiver obtained after the reporting date, is considered a non-adjusting event to be disclosed in the financial statements. ([IAS 10.21](#))
14. 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. Borrowers should refer to the COVID-19 Resource "[Going Concern and Liquidity Risk](#)" for additional details.
15. The lender should closely monitor the borrower's economic condition and financial performance. A potential breach of covenant could signal a significantly increased credit risk that requires a lifetime expected credit loss be recognized on the debt. An actual breach of debt covenant or a potential bankruptcy of the borrower could indicate that the debt is impaired, resulting in a portion or the entire debt being written off.
16. Both the lender and the borrower should perform the above assessments at each reporting period, as judgments made in the prior interim period may need to be revisited.

Troubled debt restructuring under U.S. generally accepted accounting principals (GAAP)

17. U.S. GAAP provides specific guidance on the accounting for troubled debt restructuring (TDR). A restructuring of a debt constitutes a TDR if the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. Borrowers and lenders should refer to guidance in Accounting Standards Codification (ASC) 310-40 *Receivables — Troubled Debt Restructurings by Creditors*, and ASC 470-60 *Debt-Troubled Debt Restructuring by Debtors*, respectively, to determine whether a change to an existing debt arrangement represents a TDR.
18. Financial institutions should consider the March 2020 [joint statement](#) issued by the U.S. federal and state prudential banking regulators that included guidance on their approach on the accounting for loan modifications in light of COVID-19's economic impact. Developed in consultation with the U.S. Financial Accounting Standards Board staff, this joint statement indicates that "for short-term modifications made on good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not TDRs."

Has the IFRS® Discussion Group talked about this topic?

19. The Group has had several conversations on modifications of financial instruments. The discussions listed may be helpful as you think how COVID-19 could affect the accounting for debt modifications:

Meeting Date	Topic	Meeting Report
June 21, 2018	Modifications or Exchanges of Fixed-rate and Floating-rate Financial Instruments	View Document
January 10, 2018	Modifications or Exchanges of Financial Liabilities that do not Result in Derecognition	View Document
May 30, 2017	Modifications or Exchanges of Financial Liabilities that do not Result in Derecognition	View Document
December 3, 2015	Changes to Convertible Debt	View Document

What other resources are available?

20. Do you need more information? The following publications may provide more insight:

Resources (IFRS Standards)

BDO, [“Coronavirus impacts on the accounting for financial instruments under IFRS 9 and contract assets under IFRS 15,” April 2020.](#)

KPMG, [“Have borrowers considered changes to the terms of their liabilities?” March 2020.](#)

Resources (U.S. GAAP)

PwC, Podcast, [“Accounting for debt in uncertain times: 5 things to know,” March 2020.](#)

Extracts from relevant IFRS Standards

Standard	Guidance
IFRS 9	<p data-bbox="394 363 1425 510">3.2.11 If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.</p> <p data-bbox="394 520 1425 709">3.2.12 On derecognition of a financial asset in its entirety, the difference between: (a) the carrying amount (measured at the date of derecognition) and (b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.</p> <p data-bbox="394 720 1425 993">3.3.2 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.</p> <p data-bbox="394 1003 1425 1150">3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.</p> <p data-bbox="394 1161 1425 1392">5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.</p> <p data-bbox="394 1402 1425 1898">5.4.3 When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a <i>modification gain</i> or loss in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.</p>

Standard	Guidance
	<p>5.5.12 If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognised, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument in accordance with paragraph 5.5.3 by comparing:</p> <ul style="list-style-type: none"> (a) the risk of a default occurring at the reporting date (based on the modified contractual terms); and (b) the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). <p>B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value 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, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.</p> <p>B5.4.6 If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 5.4.3 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. The adjustment is recognised in profit or loss as income or expense.</p> <p>B5.5.25 In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset in accordance with this Standard. When the modification of a financial asset results in the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset, the modified asset is considered a 'new' financial asset for the purposes of this Standard.</p> <p>B5.5.27 If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognised, that financial asset is not automatically considered to have lower credit risk. An entity shall assess whether there has been a significant increase in credit risk since</p>

Standard	Guidance
	<p>initial recognition on the basis of all reasonable and supportable information that is available without undue cost or effort. This includes historical and forward-looking information and an assessment of the credit risk over the expected life of the financial asset, which includes information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.</p>
IAS 1	<p>69 An entity shall classify a liability as current when:</p> <ul style="list-style-type: none"> (a) it expects to settle the liability in its normal operating cycle; (b) it holds the liability primarily for the purpose of trading; (c) the liability is due to be settled within twelve months after the reporting period; or (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification. <p>An entity shall classify all other liabilities as non-current.</p> <p>74 When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.</p>
IAS 10	<p>21 If non-adjusting events after the reporting period are material, non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:</p> <ul style="list-style-type: none"> (a) the nature of the event; and (b) an estimate of its financial effect, or a statement that such an estimate cannot be made.