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A Closer Look

Impact of transition from IAS 39 to IFRS 9 on the exchange or modification of financial liabilities

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Introduction

The accounting for certain modifications and exchanges of financial liabilities measured at amortised cost (e.g. bank loans and issued bonds) will change on transition from IAS 39 *Financial Instruments: Recognition and Measurement to IFRS 9 Financial Instruments*. This change arises from a clarification by the IASB in the Basis for Conclusions of the amendments to IFRS 9 *Prepayment Features with Negative Compensation* issued on 12 October 2017. The IFRS 9 accounting treatment is applicable from 1 January 2018 (the effective date of IFRS 9, or earlier if IFRS 9 is adopted early) and will need to be applied retrospectively to all affected financial liabilities that continue to be recognised on transition from IAS 39. This will result in a transition adjustment and a change to the effective interest rate for the financial liabilities affected.

In the first part of this publication we:

- give an overview of the accounting for an exchange or modification of a financial liability under both IAS 39 and IFRS 9;
- set out the process through which the accounting was clarified; and
- explain the impact of the change on transition from IAS 39 to IFRS 9 including some of the issues that may arise in practice.

The second part of this publication is a detailed illustrative example of a modification of a financial liability under IAS 39 and the effect of transitioning to IFRS 9.

Overview of treatment under IAS 39 and IFRS 9

When the terms of a financial liability are modified an entity needs to consider whether that modification is substantial. If the modification is considered substantial the original financial liability is derecognised and a new financial liability is recognised at fair value. Similarly when a borrower *exchanges* a financial liability for another with substantially different terms with the same lender the existing liability is derecognised and a new liability is recognised. The process for assessing whether a modification to the terms of a financial liability is substantial is the same under both IAS 39 and IFRS 9, as is the treatment of a *substantial* modification. However the treatment of a *non-substantial* modification is different.

When is a modification to the terms of a financial liability substantial?

Quantitatively, a modification to the terms of a financial liability is substantial if the net present value of the cash flows under the modified terms, including any fees paid net of any fees received, is at least 10 per cent different from the net present value of the remaining cash flows of the liability prior to the modification, both discounted at the original effective interest rate ('EIR'). This assessment is sometimes referred to as the '10 per cent test', and is applicable under both IAS 39 and IFRS 9.

Under IAS 39 there was some ambiguity around the accounting requirement for a non-substantial modification of a financial liability. However, it was common practice not to recognise any gain or loss at the time of a non-substantial modification. At the point of modification the carrying amount of the financial liability is revised for directly attributable transaction costs and any consideration paid to or received from the counterparty. The EIR is then adjusted to amortise the difference between the revised carrying amount and the expected cash flows over the life of the modified instrument.

It is now clear that under IFRS 9 a gain or loss should be recognised at the time of a non-substantial modification. The modification gain or loss is equal to the difference between the present value of the cash flows under the original and modified terms discounted at the original EIR. At the point of modification the carrying amount of the financial liability is revised to reflect the new cash flows discounted by the original EIR (resulting in a modification gain or loss) as well as directly attributable transaction costs and any cash paid to or received from the counterparty. The EIR is then adjusted to amortise the difference between the revised carrying amount and the expected cash flows over the life of the modified instrument. The gain or loss that is recognised immediately in the profit or loss under IFRS 9 is amortised over the life of the modified financial liability through the EIR under IAS 39.

Clarification of the requirements of IFRS 9

In November 2016 the IFRS Interpretations Committee was asked to clarify whether a non-substantial modification of a financial liability measured at amortised cost should result in the recognition of a modification gain or loss. IFRS 9 explicitly requires the recognition of a modification gain or loss for exchanges or modifications of financial assets that do not result in the derecognition of the financial asset but did not explicitly require this for financial liabilities.

In March 2017 a tentative agenda decision was issued which explained that the recognition of a modification gain or loss should be recognised for all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in the derecognition of the financial liability (i.e. a non-substantial modification). The IFRS Interpretations Committee concluded that the existing principles and requirements in IFRS 9 were adequate to support this conclusion. The tentative agenda decision also noted that if an entity was required to change its accounting policy in relation to the recognition of a modification gain or loss on transition to IFRS 9 then this change in policy would need to be applied retrospectively to all liabilities that are still recognised at the date of initial application. In light of the comments received on the tentative agenda decision the IFRS Interpretations Committee referred the issue to the IASB.

The IASB agreed with the analysis of the IFRS Interpretations Committee, and included a clarification in the Basis for Conclusions accompanying the IFRS 9 amendment Prepayment Features with Negative Compensation published on 12 Oct 2017. Because the IASB's view of the accounting for non-substantial modifications of liabilities is included in the Basis of Conclusions as a clarification rather than as an amendment to the existing requirements of IFRS 9 it is applicable on adoption of IFRS 9 (i.e. periods beginning on or after 1 January 2018 for entities who have chosen not early adopt IFRS 9). It should be noted that it therefore applies before the mandatory effective date of the amendment on prepayment features and negative compensation which is 1 January 2019 with early application permitted.[1]

What is the 'date of initial application' of IFRS 9?

For the purposes of transition from IAS 39 to IFRS 9, the date of initial application is the date when an entity first applies the requirements of IFRS 9 and must be the beginning of a reporting period. For example, the date of initial application is 1 January 2018 for an entity applying IFRS 9 for the first time for the annual period ended 31 December 2018.

Impact of transition from IAS 39 to IFRS 9

If under IAS 39, as was common practice, an entity had a policy of not recognising a gain or loss as a result of a non-substantial modification they will be required to change their accounting policy on transition from IAS 39 to IFRS 9. This change in policy will need to be applied retrospectively to all financial liabilities that are still recognised at the date of initial application. It will not need to be applied to financial liabilities that have been derecognised on or before the date of initial application of IFRS 9.

If an entity does not restate comparative periods, any adjustment required to the carrying amount of a financial liability will be recognised as an adjustment to retained earnings at the date of initial application. However, if an entity restates the comparative period then the adjustment is made at the start of the earliest period presented.

Additional considerations

The EIR of an affected liability will be different after transition to IFRS 9. The revised EIR will impact interest expense and any ratios based on interest expense (e.g. interest cover). It will also affect any future revision of cash flows, including the assessment of whether or not a subsequent modification is substantial. The change to the EIR may also affect the amortisation of any fair value hedge adjustment.

Entities may find the retrospective application of the requirements for the modification of financial liabilities challenging in practice. They will need to consider all previous modifications to financial liabilities that are not derecognised on the date of initial application, not just the most recent modification. Detailed information will be required about each historic transaction.

1. Click **here** for further information about the IFRS 9 amendment *Prepayment Features with Negative Compensation*.

Where a liability has been modified only once prior to the date of initial application the result of the derecognition assessment (i.e. determining whether a modification is substantial or not) should be consistent under IAS 39 and IFRS 9. However, in some cases care will be needed to correctly identify non-substantial modifications. It should not be assumed that simply because no gain or loss was recognised as a result of a re-financing or debt restructuring that this was a non-substantial modification. For example, if new on-market financing is agreed with a bank at the point that the previous financing matured then this is not affected by the clarification for modifications because this would have resulted in settlement of the original liability and recognition of a new liability with no gain or loss rather than a modification.

Where a liability has been modified on multiple occasions prior to the date of initial application it is possible that the change to the EIR as a result of an earlier modification will change the outcome of the derecognition assessment of a subsequent modification through the '10 per cent test'.

Illustrative example

This example illustrates the application of the derecognition requirements of IAS 39 and IFRS 9 to a modified bond liability measured at amortised cost. The example has been split in to 3 parts:

- *Part 1: Background and derecognition assessment,* sets out the terms of the instrument before and after the modification and illustrates both the EIR calculation on initial recognition and the application of 'the 10% test'. The analysis in this section is performed under IAS 39. However it is also consistent with the requirements of IFRS 9;
- *Part 2: Continued recognition under IAS 39,* illustrates the accounting for a 'non-substantial' modification under IAS 39; and
- *Part 3: Transition to IFRS 9,* illustrates the accounting for the same 'non-substantial' modification under IFRS 9 and the adjustments required on transition from IAS 39 to IFRS 9.

In the example, the bond is issued by Entity A which reports under IFRS and has sterling functional currency. 1 January 2018 is the date of initial application of IFRS 9 for Entity A. Entity A has elected not to restate its comparatives on transition from IAS 39 to IFRS 9.

Where a number has been highlighted in green it indicates that it will be used in a calculation later in the example.

Part 1: Background and derecognition assessment

Entity A issues a fixed rate bond to Bank B on 1 January 2012. Under the terms of the bond Entity A will pay interest annually in arrears on 31 December each year up to and including the maturity date of 31 December 2020. Interest will be paid at a rate of 4% on the principal of £100m and the principal amount will be repaid on 31 December 2020. On 1 January 2012 Entity A receives £100m (the fair value of the bond) in cash from Bank B and pays £5m in directly attributable transaction costs to third parties.

The bond is initially recognised at £95m (the fair value of the bond less directly attributable transaction costs) and subsequently accounted for at amortised cost. The EIR of the bond is calculated as 4.69%. In the absence of any modification the amortised cost of the bond at the beginning and end of each year would be as follows:

Year	Amortised cost on 1 January	Interest expense @ EIR	Cash flow on 31 December	Amortised cost on 31 December
	(a)	(b = a * 4.69%)	(c)	(d = a + b + c)
2012	95.00	4.46	(4.00)	95.46
2013	95.46	4.48	(4.00)	95.94
2014	95.94	4.50	(4.00)	96.44
2015	**96.44**	4.53	(4.00)	96.97
2016	96.97	4.55	(4.00)	97.52
2017	97.52	4.58	(4.00)	98.10
2018	98.10	4.60	(4.00)	98.70
2019	98.70	4.64	(4.00)	99.34
2020	99.34	4.66	(104.00)	–

Entity A and Bank B agree to modify the terms of the bond on 1 January 2015 as follows:

- the maturity of the bond is extended by two years to 31 December 2022;
- the interest rate is reduced by 0.5% to 3.5%; and
- the principal increased by £10m to £110m.

As part of this modification, on 1 January 2015 Entity A receives £10m from Bank B and pays £1m in directly attributable transaction costs to third parties.

If the terms of the modified bond are substantially different, Entity A must derecognise the original bond and recognise the modified bond as a new financial liability. The terms are substantially different if the discounted present value of the cash flows under the modified terms, including any fees paid net of any fees received and discounted using the original EIR, is at least 10% different from the discounted present value of the remaining cash flows of the original bond liability. For this purpose, Entity A excludes the transaction costs paid to third parties. In this case, the present value of the remaining cash flows of the original bond liability on 1 January 2015 is equal to its amortised cost carrying amount of £96.44. Entity A calculates the present value of the cash flows under the modified terms discounted at the original EIR as follows:

	1 Jan 2015	31 Dec 2015	31 Dec 2016	31 Dec 2017	31 Dec 2018	31 Dec 2019	31 Dec 2020	31 Dec 2021	31 Dec 2022	Total for all periods
Cash received on modification	10.00									
Interest @ 3.5%		(3.85)	(3.85)	(3.85)	(3.85)	(3.85)	(3.85)	(3.85)	(3.85)	
Repayment of principal									(110.00)	
Total cash flows	**10.00**	**(3.85)**	**(3.85)**	**(3.85)**	**(3.85)**	**(3.85)**	**(3.85)**	**(3.85)**	**(113.85)**	
Discount factor @ 4.69%	1.000	0.955	0.912	0.871	0.832	0.795	0.759	0.725	0.693	
Present value of total cash flows	**10.00**	**(3.68)**	**(3.51)**	**(3.36)**	**(3.20)**	**(3.06)**	**(2.92)**	**(2.79)**	**(78.88)**	**(91.40)**

The difference between the present value of the cash flows under the original and modified terms is 5.2% ([91.40 – 96.44]/96.44). The difference is less than 10% and there are no other qualitative differences, therefore the modification is not substantial and is not considered an extinguishment of the original debt (i.e. it is a non-substantial modification).

Entity A performs this analysis under IAS 39 as the initial recognition and modification of the bond occurred prior to its date of initial application of IFRS 9. However, it is also consistent with the requirements of IFRS 9 as the derecognition provisions in IAS 39 have been carried over into the new standard.

Part 2: Continued recognition under IAS 39

Under IAS 39, Entity's A accounting policy has been not to recognise a gain or loss as a result of a non-substantial modification. In accordance with this, Entity A first adjusts the carrying amount of the bond at the date of the modification and then recalculates the EIR to spread any gain or loss over the life of the modified bond. Entity A adjusts the carrying amount of the bond as at 1 January 2015 for the cash received on modification and the directly attributable transaction costs as follows:

	Carrying amount
Carrying amount before modification	96.44
– Plus: cash received on modification	10.00
– Less: directly attributable transaction costs	(1.00)
Carrying amount after modification	**105.44**

The revised EIR of the bond is calculated as 4.12%. In the absence of any further modification (or transition to IFRS 9) the amortised cost of the bond at the beginning and end of each year would be as follows:

Year	Amortised cost on 1 January	Interest expense @ EIR	Cash flow on 31 December	Amortised cost on 31 December
	(a)	(b = a * 4.12%)	(c)	(d = a + b + c)
2015	105.44	4.35	(3.85)	105.94
2016	105.94	4.36	(3.85)	106.45
2017	106.45	4.38	(3.85)	106.98
2018	**106.98**	4.41	(3.85)	107.54
2019	107.54	4.43	(3.85)	108.12
2020	108.12	4.45	(3.85)	108.72
2021	108.72	4.48	(3.85)	109.35
2022	109.35	4.50	(113.85)	–

Part 3: Transition to IFRS 9

Entity A must apply the requirements of IFRS 9 in relation to non-substantial modifications of financial liabilities fully retrospectively unless the financial liability has been derecognised prior to the date of initial application. Under IFRS 9, the gain or loss recognised as a result of a non-substantial modification is equal to the difference between the present value of the cash flows under the original and modified terms discounted at the original EIR. In this case Entity A would have recognised a gain of **£5.04m** (£96.44m - £91.40m) at the date of modification.

Under IFRS 9, Entity A would have adjusted the carrying amount of the bond at the date of modification in order to recognise the modification gain or loss (in addition to the adjustments made under IAS 39). The revised carrying amount as at 1 January 2015 would have been calculated as follows:

	Carrying amount (CU)
Carrying amount before modification	96.44
– Plus: cash received on modification	10.00
– Less: modification gain	(5.04)
– Less: directly attributable transaction costs	(1.00)
Carrying amount after modification	**100.40**

Once the carrying amount of the bond has been adjusted Entity A then recalculates the EIR to spread the directly attributable transaction costs over the life of the modified bond. The revised EIR of the bond is calculated as 4.84%. In the absence of any further modification the amortised cost of the bond at the beginning and end of each year under IFRS 9 would be as follows:

Year	Amortised cost on 1 January	Interest expense @ EIR	Cash flow on 31 December	Amortised cost on 31 December
	(a)	(b = a * 4.84%)	(c)	(d = a + b + c)
2015	100.40	4.87	(3.85)	101.42
2016	101.42	4.91	(3.85)	102.48
2017	102.48	4.96	(3.85)	103.59
2018	**103.59**	5.01	(3.85)	104.75
2019	104.75	5.07	(3.85)	105.97
2020	105.97	5.13	(3.85)	107.25
2021	107.25	5.19	(3.85)	108.59
2022	108.59	5.26	(113.85)	–

If a non-substantial modification occurred prior to the date of initial application, and the liability continues to be recognised at the date of initial application, the carrying amount of the liability will be adjusted on transition to IFRS 9. The difference between the carrying amount of the liability under IAS 39 and IFRS 9 is recognised in opening retained earnings. In this case Entity A would adjust the carrying amount of the bond to £103.59m on 1 January 2018 and recognise the corresponding adjustment of £3.39m (£106.98m - £103.59m) in opening retained earnings

Key contacts

Global IFRS Leader
Veronica Poole
ifrsglobalofficeuk@deloitte.co.uk

IFRS centres of excellence		
Americas		
Canada	Karen Higgins	ifrs@deloitte.ca
Mexico	Miguel Millan	mx-ifrs-coe@deloittemx.com
United States	Robert Uhl	iasplus-us@deloitte.com
Asia-Pacific		
Australia	Anna Crawford	ifrs@deloitte.com.au
China	Stephen Taylor	ifrs@deloitte.com.cn
Japan	Shinya Iwasaki	ifrs@tohmatsu.co.jp
Singapore	James Xu	ifrs-sg@deloitte.com
Europe-Africa		
Belgium	Thomas Carlier	ifrs-belgium@deloitte.com
Denmark	Jan Peter Larsen	ifrs@deloitte.dk
France	Laurence Rivat	ifrs@deloitte.fr
Germany	Jens Berger	ifrs@deloitte.de
Italy	Massimiliano Semprini	ifrs-it@deloitte.it
Luxembourg	Eddy Termaten	ifrs@deloitte.lu
Netherlands	Ralph Ter Hoeven	ifrs@deloitte.nl
Russia	Maria Proshina	ifrs@deloitte.ru
South Africa	Nita Ranchod	ifrs@deloitte.co.za
Spain	Cleber Custodio	ifrs@deloitte.es
United Kingdom	Elizabeth Chrispin	deloitteifrs@deloitte.co.uk

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