STAFF PAPER

November 2016

IFRS® Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IFRS 9 *Financial Instruments*—Modification/exchange of financial liabilities that do not result in derecognition		
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This paper was initially included in the set of papers to be discussed at the Interpretations Committee meeting in September 2016. However, it was not discussed at that meeting. Other than to update the agenda paper number and date, the content of the paper has not been changed.

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request regarding IFRS 9 *Financial Instruments*. The request asks the Interpretations Committee to clarify whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in the derecognition of the financial liability.

2. The objective of this paper is to provide the Interpretations Committee with a summary of the issue and the staff's analysis and recommendation.

Structure of the paper

3. This paper is organised as follows:

   (a) background;

   (b) summary of outreach conducted;

   (c) staff analysis;

(d) assessment against the Interpretations Committee's agenda criteria;

(e) staff recommendation;

(f) questions for the Interpretations Committee;

(g) Appendix A—Proposed wording for tentative agenda decision; and

(h) Appendix B—Submission received.

Background

The issue

4. The submitter has asked the Interpretations Committee to clarify whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in the derecognition of the financial liability. According to paragraph 3.3.2 of IFRS 9:

> 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.

5. In addition, paragraph B3.3.6 of IFRS 9 states that:

> 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.

6. The submitter highlights that these requirements were carried forward unchanged to IFRS 9 from IAS 39 *Financial Instruments: Recognition and Measurement*.[1] In addition, the submitter notes that IFRS 9 contains new requirements for the accounting for modifications of financial assets. Specifically, paragraph 5.4.3 of IFRS 9 requires an entity to recognise any gain or loss arising from a modification of a financial asset that does not result in its derecognition in profit or loss immediately. 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. Paragraph 5.4.3 of IFRS 9 and the definition of a 'modification gain or loss' in Appendix A of IFRS 9 are reproduced below [*emphasis added*]:

> Modification of contractual cash flows
>
> 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 *modification gain 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

[1] Paragraphs 40 and AG62 of IAS 39 were carried forward to IFRS 9 unchanged. These paragraphs of IAS 39 correspond to paragraphs 3.3.2 and B3.3.6 of IFRS 9.

the modified financial asset.

Modification gain or loss (Appendix A of IFRS 9)

The amount arising from adjusting the *gross carrying amount of a financial asset* to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's *original effective interest rate* (or the original 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. […]

7. The submitter states that there are divergent views on how the introduction of the new requirements relating to modifications of financial assets might affect the accounting for modifications of financial liabilities. The submitter has identified two views.

View One—recognise a gain or loss at the date of modification

8. Proponents of this view argue that any change in the contractual cash flows (including changes arising from a modification or an exchange of a financial liability that continues to be recognised) leads to a re-estimation of the contractual cash flows, which are discounted at the original effective interest rate (EIR) to determine the new amortised cost amount. An entity recognises the resulting adjustment as a gain or loss in profit or loss at the date of the modification.

9. According to these proponents, this view is clearer in IFRS 9 than in IAS 39. This is because paragraph B5.4.6 of IFRS 9 includes a parenthesis that it is not in paragraph AG8 of IAS 39. The purpose of this parenthesis is to specifically exclude from the requirements in paragraph B5.4.6 those modifications of financial assets that are subject to paragraph 5.4.3 of IFRS 9. This, they argue, implies that modifications that are not subject to paragraph 5.4.3 of IFRS 9 are subject to the more general requirements of paragraph B5.4.6. Paragraph B5.4.6 of IFRS 9 is reproduced below [*emphasis added*]:

> 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.

View Two—do not recognise a gain or loss at the date of modification

10. Proponents of this view contend that when a financial liability is modified or exchanged and it is not derecognised, an entity adjusts the amortised cost at the date of the modification or exchange **only** to reflect costs or fees incurred as part of the modification or exchange. They state that paragraph B3.3.6 of IFRS 9 is clear that an entity does not recognise such costs or fees in profit or loss at the date of the modification or exchange, and instead amortises them over future periods. Consequently, they infer that any changes in future contractual cash flows arising as a result of a modification or exchange are also reflected in future periods through the application of a recalculated EIR. They state that, when a financial liability has been modified but not derecognised, the recognition of a gain or loss in profit or loss would not be consistent with the conclusion that the financial liability has not been extinguished.

11. In addition, proponents of this view note that the derecognition requirements in IAS 39 were based on US GAAP requirements. In considering the US GAAP requirements in Subtopic 470-50 of the FASB Accounting Standards Codification, proponents of View Two conclude that, if the original financial liability and the modified financial liability are not substantially different, then an entity does not account for the exchange or

modification in the same manner as if the liability were extinguished. Instead, an entity computes a new EIR based on the carrying amount of the original financial liability and the revised cash flows. The relevant excerpt from US GAAP is reproduced below:

Modifications and Exchanges—Subsequent Accounting for Modifications and Exchanges if Extinguishment Accounting Is Not Applied—ASC470-50-40-14

> If it is determined that the original and new debt instruments are not substantially different, then a new effective interest rate shall be determined based on the carrying amount of the original debt instrument, adjusted for an increase (but not a decrease) in the fair value of an embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) resulting from the modification, and the revised cash flows.

Summary of outreach conducted

12. In order to gather information about the issue described in the submission, the staff sent requests to securities regulators, members of the International Forum of Accounting Standard-Setters (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms (‘accounting firms’). Specifically, we asked:

    (a) the most commonly observed method that entities use to account for modifications or exchanges of financial liabilities that do not result in the derecognition of the financial liability;

    (b) their understanding of the requirements in IFRS 9 for the accounting of such modifications or exchanges; and

    (c) their thoughts on whether those requirements might contribute to diversity in practice.

Responses

13. We received 20 responses from one group of regulators, 14 national standard-setters; and five accounting firms. The views received represent informal opinions as opposed to the formal views of those organisations.

14. The geographical breakdown of the responses from national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	3
Europe	4
Americas	4
Middle East	1
Oceania	1
Africa	1
Total respondents	**14**

Summary of outreach responses

15. As IFRS 9 is not yet effective, the majority of respondents referred to their experience with IAS 39.

16. The responses revealed that View Two is the most commonly observed approach applying IAS 39. Some of those respondents were of the view that a modification of the original contractual cash flows of a financial liability is within the scope of paragraph AG62 of IAS 39 as opposed to paragraph AG8. This view leads to the amortisation of the gain or loss arising from a modification or exchange over the remaining term of the instrument (View Two). According to these respondents, the requirements in IAS 39 distinguish between changes in estimates of contractual cash flows due to, for example, a change in expectations about a prepayment feature (ie paragraph AG8 of IAS 39) and a modification of the contractual cash flows due to, for example, a renegotiation of the contractual terms of an instrument (ie paragraphs 40 and AG62 of IAS 39).

17. Given that the requirements in IAS 39 have been carried forward to IFRS 9 without major changes, many respondents are of the opinion that the Board's intention was to preserve the status quo. Consequently, many respondents consider that practice should not change when IFRS 9 is applied.

18. However, some observe that the new requirements for the accounting for modifications of financial assets in paragraph 5.4.3 of IFRS 9, along with the changes to paragraph B5.4.6, could be read to imply that View One is the appropriate answer when applying IFRS 9. Some said that it is unclear whether the accounting for modifications or exchanges of financial liabilities should be the same as that for modifications of financial assets. Consequently, some respondents think that there is a risk of diversity in the application of IFRS 9 if this issue is not clarified. Some said that, in the absence of explicit requirements for modifications or exchanges of financial liabilities that are not derecognised, they think that both View One and View Two would be acceptable applications of the requirements in IFRS 9.

Staff analysis

19. The submitter has asked for clarity as to whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in the derecognition of the financial liability. For the purpose of analysing this issue, the staff have considered:

    (a) the principles underpinning, and the features of, the amortised cost method (see paragraphs 20–38 of this paper); and

    (b) the appropriate amortised cost of the financial liability at the date of the modification (see paragraphs 39–46 of this paper).

Principles underpinning, and features of, the amortised cost method

20. IFRS 9 describes amortised cost as ‘a relatively simple measurement technique that allocates interest over the relevant time period using the effective interest rate.’[2] Appendix A of IFRS 9 defines ‘effective interest rate’ as (*emphasis added*):

> *The rate that exactly discounts estimated future cash payments or receipts through the expected life of the* financial asset or *financial liability* to the gross carrying amount of a financial asset or *to the amortised cost of a financial liability*. When calculating the effective interest rate, *an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument* (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. […]

21. As stated above, in the case of a financial liability, the effective interest rate (EIR) discounts estimated future cash flows through the expected life of the financial liability to its amortised cost. Appendix A of IFRS 9 defines ‘amortised cost of a financial asset or financial liability’ as:

> The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

22. The staff have used the numerical example included in the submission to illustrate the accounting implications of each of the views set out in paragraphs 8–11 of this paper.

[2] See paragraph BC4.158 of IFRS 9.

23. The submission includes the example of a financial liability with the following features:

> A financial liability is initially recognised at an amortised cost of CU98m[3], reflecting proceeds at par of CU100m less transaction costs of CU2m. The financial liability has a term of seven years and bears a fixed interest rate of 6 per cent paid annually.

24. Table 1 illustrates the cash flows arising from the financial liability described above:[4]

TABLE 1 - Cash flows arising from the financial liability throughout its expected life (in millions of CU)								
Period	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Proceeds	100							
Coupon		-6	-6	-6	-6	-6	-6	-6
Principal								-100
Transaction costs	-2							
	98	**-6**	**-6**	**-6**	**-6**	**-6**	**-6**	**-106**

25. Using the definition of EIR included in paragraph 21 of this paper, the EIR that exactly discounts the estimated future cash payments (ie -6, … , -6, -106) through the expected life of the financial liability to its amortised cost of CU98m, is 6.36 per cent.

26. The allocation of interest expense using the EIR of 6.36 per cent results in the following amortisation schedule (Table 2):

TABLE 2 - Amortisation schedule - Interest expense allocated using EIR of 6.36% (in millions of CU)							
Period	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Opening carrying amount	98.00	98.24	98.49	98.75	99.04	99.34	99.66
Interest expense	6.24	6.25	6.27	6.28	6.30	6.32	6.34
Cash	-6	-6	-6	-6	-6	-6	-106
Closing carrying amount	**98.24**	**98.49**	**98.75**	**99.04**	**99.34**	**99.66**	**0.00**

27. According to the example included in the submission, the financial liability is modified as follows:

> At the end of year 2, the coupon of the financial liability is reduced to CU4m per annum and the final redemption amount is increased to CU130m. In

[3] In this Agenda Paper, currency amounts are denominated in 'currency units' (CU).

[4] The numerical information in Tables 1–5 of this paper has been extracted from the example included in the submission.

addition, the term of the financial liability is extended for a further two years. Third party costs amounting to CU3m are incurred as part of the modification.

28. Table 3 shows the modified contractual cash flows for the period from year three to year nine, discounted at the original EIR[5] of 6.36 per cent:

TABLE 3 - Modified cash flows based on a modification at the end of year 2 (in millions of CU)								
Period	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Modified coupon payment		-4	-4	-4	-4	-4	-4	-4
Modified principal								-130
Total Cash Flows		**-4**	**-4**	**-4**	**-4**	**-4**	**-4**	**-134**
Discount factor at the original EIR (6.36%)		0.94	0.88	0.83	0.78	0.73	0.69	0.65
Discounted cash flows		**-3.76**	**-3.54**	**-3.32**	**-3.13**	**-2.94**	**-2.76**	**-87.01**
Sum of discounted cash flows	**-106.46**							

29. As shown in Table 2, the amortised cost of the financial liability at the end of year two is **CU98.49m**. As shown in Table 3, the modified contractual cash flows of the financial liability discounted at the original EIR equal **CU106.46m**. As set out in the submission, it is assumed that the modification does not lead to the derecognition of the financial liability.

30. The submission asks whether the entity recognises the difference between the modified contractual cash flows and the amortised cost before the modification (ie CU106.46 – CU98.49 = **CU7.97m**) immediately in profit or loss at the modification date (ie at the end of year 2) or whether it should, instead, amortise the difference over the remaining expected term of the financial liability. The paragraphs below illustrate these two options.

Immediate recognition of the difference in profit or loss (View One)

31. The amortised cost of the modified financial liability is CU106.46m at the date of the modification (see Table 3). Consequently, the entity recognises a loss of CU7.97m (ie CU106.46 – CU98.49 = CU7.97m) in profit or loss at the date of the modification.

32. Additionally, according to paragraph B3.3.6 of IFRS 9, any costs or fees incurred in the modification adjust the amortised cost of the modified financial liability and are amortised over the remaining life of the modified financial liability. In this example, the entity adjusts the amortised cost of the financial liability to account for the third

[5] This is in accordance with paragraph B3.3.6 of IFRS 9 (reproduced in paragraph 5 of this paper).

party costs arising from the modification amounting to CU3m. This results in an adjusted amortised cost of the financial liability of CU103.46m (ie CU106.4m – CU3m).

33. For the purposes of allocating interest expense throughout the modified expected life of the financial liability, the entity computes a revised EIR that discounts the modified contractual cash flows back to the adjusted amortised cost of the financial liability (ie CU103.46m) at the date of the modification. In this case, the revised EIR is 6.84 per cent. Table 4 illustrates these calculations:

TABLE 4 - View 1 - Difference due to modification recognised in PL immediately								
Periods		**3**	**4**	**5**	**6**	**7**	**8**	**9**
Carrying amount at the end of year 2	98.49							
Difference due to modification	7.97	Recognised immediately in profit or loss						
Sum of discounted cash flows	**106.46**	Amortised						
Transaction costs	-3							
Revised carrying amount	**103.46**	-4	-4	-4	-4	-4	-4	-134
New effective interest rate	6.84%							
Opening carrying amount		**103.46**	**106.54**	**109.83**	**113.35**	**117.11**	**121.12**	**125.42**
Interest expense (using new EIR 6.84%)		7.08	7.29	7.52	7.76	8.02	8.29	8.58
Cash		-4	-4	-4	-4	-4	-4	-134
Closing carrying amount		**106.54**	**109.83**	**113.35**	**117.11**	**121.12**	**125.42**	**0.00**

Amortisation of the difference over the modified expected life of the financial liability (View Two)

34. An entity would consider the amortised cost of the financial liability at year two to be CU98.49m (see Table 2). Applying paragraph B3.3.6 of IFRS 9, the entity adjusts the amortised cost of the financial liability to account for the third party costs arising from the modification amounting to CU3m. This results in the adjusted amortised cost of the financial liability of CU95.49m (ie CU98.49m – CU3m).

35. For the purposes of allocating interest expense throughout the modified expected life of the financial liability, the entity computes the revised EIR that discounts the modified contractual cash flows back to the amortised cost of the financial liability (ie CU95.49m) at the date of the modification. In this case, the revised EIR is 8.21 per cent. Table 5 illustrates these calculations:

TABLE 5 - View 2 - Difference due to modification amortised over the expected life of the financial liability								
Periods		**3**	**4**	**5**	**6**	**7**	**8**	**9**
Carrying amount at the end of year 2	98.49	Amortised						
Transaction costs	-3							
Revised carrying amount	**95.49**	-4	-4	-4	-4	-4	-4	-134
New effective interest rate	8.21%							
Opening carrying amount		**95.49**	**99.33**	**103.49**	**107.99**	**112.86**	**118.13**	**123.83**
Interest expense (using new EIR 8.21%)		7.84	8.16	8.50	8.87	9.27	9.70	10.17
Cash		-4	-4	-4	-4	-4	-4	-134
Closing carrying amount		**99.33**	**103.49**	**107.99**	**112.86**	**118.13**	**123.83**	**0.00**

Comparing the two views

36. View One considers that the difference between the modified contractual cash flows of the financial liability discounted using the original EIR and the amortised cost of the original financial liability (ie CU106.46 – CU98.49 = CU7.97m) adjusts the latter at the date of the modification. The accounting entry that reflects this is as follows:

	Dr	(Cr)
Financial liability		CU7.97m
Profit or loss	CU7.97m	

37. View Two does not adjust the amortised cost of the financial liability at the date of modification to reflect the modified contractual cash flows of the financial liability. One of the consequences of View Two is that it results in the financial liability having a lower amortised cost throughout its expected remaining life. In addition, because an entity applying View Two needs a higher EIR (8.21 per cent versus 6.84 per cent) to discount the modified contractual cash flows to get to the lower amortised cost of the modified financial liability, then this results in higher interest expense allocated during each reporting period.

38. As the example demonstrates, the difference in views does not only affect the recognition of interest expense over the life of the modified financial liability, but it also affects the amortised cost of the financial liability. Consequently, the staff are of the view that our analysis should not only focus on the appropriateness of the recognition of a gain or loss in profit or loss arising from a modification or exchange when a financial liability has not been derecognised. Rather, the analysis should also focus on the appropriate amortised cost of the financial liability at the date of the modification (see paragraph 39).

What is the appropriate amortised cost of the financial liability at the date of the modification?

39. The staff have analysed this question considering:

(a) whether the accounting for revisions of estimates differs from the accounting for modifications;

(b) measurement of financial assets and financial liabilities at amortised cost;

(c) the appropriateness of the immediate recognition of a gain or loss in profit or loss.

Does the accounting for revisions of estimates differ from the accounting for modifications?

40. One of the arguments in support of View Two is that paragraph AG8 of IAS 39, which deals with the accounting for revisions of estimates of payments or receipts, would not apply when accounting for modifications of financial liabilities. Applying View Two, only paragraphs 40 and AG62 of IAS 39 would apply to the accounting for modifications of financial liabilities.

41. The staff are of the view that, upon modification, a modified financial asset or modified financial liability continues being the same original financial asset or financial liability (if it is not derecognised). Because an entity retains the same financial asset or financial liability, the staff do not consider that there is a basis on which to distinguish the accounting for changes in cash flows that arise from revisions of estimates (such as changes in the prepayment features of an instrument) from the accounting for modifications (such as renegotiations of the contractual terms of the instrument). Consequently, when the instrument is not derecognised, the staff are of the view that, for both revisions of estimates and modifications, an entity remeasures the gross carrying amount (in the case of financial assets) or the amortised cost (in the case of financial liabilities). An entity remeasures these amounts by discounting the modified contractual cash flows using the financial instrument's original EIR. This approach reflects View One.

42. The staff's view is confirmed by paragraph BC5.233 of IFRS 9 in which the Board stated that '… these requirements were consistent with the previous requirements in paragraph AG8 of IAS 39, which did not differentiate between modifications based on the reason for the modification.' [6]

Measurement of Financial Assets and Financial Liabilities at Amortised Cost

43. Paragraph 5.4.3 of IFRS 9 deals with the accounting for modifications of contractual cash flows of financial assets (*emphasis added*):

> 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 *modification gain 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.

44. The requirements above reflect that the modified contractual terms do not challenge the continuation of the original financial asset (ie the financial asset is the same one as before the modification even though its contractual terms have been modified). Because the modified financial asset continues to be the same financial asset, its original EIR is used to discount the modified contractual cash flows. The staff are of the view that this applies equally in the case of financial liabilities because the

[6] Paragraph BC5.233 states 'The IASB further noted that these requirements were consistent with the previous requirements in paragraph AG8 of IAS 39, which did not differentiate between modifications based on the reason for the modification. Paragraph AG8 applied to all revisions of estimates of payments or receipts. This is because amortised cost is a measurement method whereby the carrying amount equates to the present value of the estimated future cash payments or receipts discounted at the effective interest rate. Consequently, the amortised cost amount should be updated in all cases in which those cash flows are modified (or expectations change other than in respect of impairment changes).

modified financial liability is the same original financial liability. Consequently, an entity determines the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original EIR of the financial liability. This approach reflects View One.

45. The definition of amortised cost in Appendix A to IFRS 9 applies equally to financial liabilities as to financial assets. Consequently, the staff contend that the principles underpinning the accounting for modifications of financial assets do not differ from the principles underpinning the accounting for modification of financial liabilities, when both instruments are measured at amortised cost.

The appropriateness of the immediate recognition of a gain or loss in profit or loss

46. As mentioned in paragraph 10, supporters of View Two think that the immediate recognition of a gain or loss in profit or loss arising from a modification or exchange is contrary to the fact that the financial liability has not been derecognised. The staff's view is that the resulting gain or loss arising from a modification reflects the fact that changes to the contractual terms result in an increase or decrease of the gross carrying amount of the financial asset or amortised cost of the financial liability. Accordingly, an entity should recognise that effect in profit or loss at the date of the modification.

Conclusion

47. On the basis of the analysis undertaken, the staff agree with View One. The staff consider that the requirements in IFRS 9, in particular paragraph B5.4.6 in IFRS 9, require an entity to consider any revisions in its estimated cash flows when remeasuring the gross carrying amount of the financial asset or amortised cost of the financial liability as the estimated future contractual cash flows discounted at the financial instrument's original EIR. The entity recognises the adjustment in profit or loss.

Question for the Interpretations Committee

Question 1 for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff analysis set out in paragraphs 20–47?

Agenda criteria assessment

48. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:[7]

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Yes**. On the basis of our analysis of the outreach responses, the staff consider that the issue is expected to have a widespread effect on the adoption of IFRS 9. The outreach results have not provided evidence to assess whether this would represent a material effect on those entities affected.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Yes**. Many of the outreach responses indicate that it is expected that entities will apply the same approach in IFRS 9 as that adopted when applying IAS 39 (ie predominantly, View Two). Some respondents also said that the new requirements for modifications of financial assets may cause entities to consider applying View One when implementing IFRS 9.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**No.** The staff think that the existing requirements in IFRS 9 are sufficiently clear to enable an entity to account for modifications of financial liabilities that do not result in derecognition.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.

[7] These criteria can be found in the *IFRS Foundation Due Process Handbook*.

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable.

Staff recommendation

49. It is clear from the outreach responses that views are mixed about how to account for a modifications or exchange of a financial liability that do not result in the derecognition of the financial liability when applying IFRS 9. Thus, it is also clear that some clarification of how to apply the requirements would be helpful.

50. We think that there are two possible ways that the Interpretations Committee could provide that clarity:

    (a) Develop an Interpretation to address the accounting for such modifications or exchanges of financial liabilities.

    (b) Issue an Agenda Decision setting out how to apply the relevant requirements of IFRS 9.

51. The main advantage of developing an Interpretation is that it provides clarity about the accounting to be applied within authoritative IFRS literature. Without an Interpretation, there would continue to be a risk that entities would apply different approaches when applying IFRS 9. If the Interpretations Committee disagrees with the staff conclusion that the existing requirements in IFRS 9 are sufficiently clear with respect to the accounting for modifications or exchanges of financial liabilities, then we recommend that the Interpretations Committee proceed to develop an Interpretation.

52. The main advantage of issuing an Agenda Decision is that it is a more efficient method for providing clarity about the accounting for modifications or exchanges of financial liabilities. Subject to the Interpretations Committee discussions and

comments received, an Agenda Decision could be finalised in the first quarter of 2017. If we decide to develop an Interpretation, the process would take considerably longer, and thus it would take further time to provide clarity about how to apply the relevant requirements in IFRS 9.

53. The staff recommend that the Interpretations Committee should not add this issue to its agenda, and thus we recommend issuing a tentative agenda decision. This is because, in our view, the existing requirements in IFRS 9 are sufficiently clear to enable an entity to account for modifications or exchanges of financial liabilities that do not result in derecognition. We think that an agenda decision provides an efficient and effective means of clarifying how to apply the requirements in IFRS 9.

54. The staff have set out proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions for the Interpretations Committee

Questions 2 and 3 for the Interpretations Committee
2. Does the Interpretations Committee agree with the staff recommendation set out in paragraphs 49–54? 3. If the Interpretations Committee agrees with the staff recommendation, does the Interpretations Committee have any comments on the drafting of the tentative agenda decision set out in Appendix A?

Appendix A—Tentative agenda decision

A1. The staff propose the following wording for the tentative agenda decision.

IFRS 9 *Financial Instruments*—Modification or exchange of financial liabilities that do not result in derecognition

The Interpretations Committee received a request to clarify the requirements in IFRS 9 relating to modifications or exchanges of financial liabilities. More specifically, the request asked whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in derecognition of the financial liability.

The Interpretations Committee observed the following:

(a) applying paragraph B5.4.6 of IFRS 9, if an entity revises its estimates of payments or receipts, then it adjusts the amortised cost of a financial liability to reflect actual and revised estimated cash flows. The entity recalculates the amortised cost of the financial liability as the present value of the estimated future contractual cash flows discounted at the financial liability's original effective interest rate, and recognises the adjustment in profit or loss as income or expense.

(b) the requirements in paragraph B5.4.6 apply to changes in the cash flows of a financial liability that arise from a modification of its contractual terms. Such a modification triggers the recalculation of the amortised cost of a financial liability in the same way as do revisions of estimated future cash flows.

On the basis of these observations, the Interpretations Committee noted that, in applying paragraph B5.4.6 of IFRS 9 to the accounting for modifications or exchanges of financial liabilities, an entity recalculates the amortised cost of a modified financial liability by discounting all modified contractual cash flows using the original effective interest rate of the financial liability. The entity recognises the adjustment to the amortised cost of the financial liability in profit or loss as income or expense.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

Suggested agenda item: Modification/exchange of financial liabilities that do not result in derecognition under IFRS 9 *Financial Instruments*

It has come to our attention that there are divergent views on whether a gain or loss should be recognised in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in derecognition of the financial liability.

Under IAS 39 *Financial Instruments: Recognition and Measurement*, specific guidance exists when a modification of a financial liability leads to either derecognition or continued recognition of the original financial liability (IAS 39:40, IAS 39:AG62). If the modification is considered to be not substantial, it 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 (IAS 39:AG62). This guidance was carried over unchanged into IFRS 9 as IFRS 9:3.3.2 and IFRS 9:B3.3.6.

IFRS 9(2014) introduced new guidance on the modification of financial assets. According to IFRS 9:5.4.3, any modification gain or loss from a modification that does not result in derecognition of the financial asset has to be recognised in profit or loss immediately. 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. The modification gain or loss is the amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows (IFRS 9 Appendix A).

Divergent views exist on how the introduction of new guidance on modification of financial assets might affect the accounting for modification of financial liabilities. We note that it was not the IASB's intention to change the requirements for derecognition of financial assets and financial liabilities when IFRS 9 was first finalised. However, issuance of the new guidance on financial assets clearly changed that intent as far as financial assets are concerned.

To illustrate:

Entity A has a bank borrowing that is recognised as a financial liability with an amortised cost amount of CU98m (reflecting the proceeds at par of CU100 less transaction costs of CU2) at initial recognition. The borrowing bears interest at 6% fixed paid annually with a term of seven years. The effective interest rate is 6.36%.

At the end of year two, Entity A modifies the borrowing with the lender to reduce the coupon to CU4 per annum, increase the final redemption amount to CU130 and extend the term for a further two years. Third party costs of CU3 are incurred in the modification[8].

[8] For the purpose of this submission third party costs are not included in the 10 per cent test. We understand different views may exist whether third party costs should be included, however, this issue is not considered as part of this submission.

Entity A applies the ‘10 per cent’ test and concludes that the modified cash flows are not substantially different and therefore the financial liability is not accounted for as being extinguished.

Full calculations are illustrated in the Appendix to this letter.

We note there are two views:

View 1 - recognise a gain/loss at the date of modification

According to this view, any change in contractual cash flows (including changes arising from the modification/exchange of a financial liability that continues to be recognised) must lead to a re-estimation of the contractual cash flows discounted by the original effective interest rate to determine the new amortised cost carrying amount.

Proponents of View 1 argue that, this view is made clearer in IFRS 9 than was the case in IAS 39, as when IFRS 9:B5.4.6 was drafted it included parentheses not previously in IAS 39:AG8 that specifically excludes those modifications of financial assets that are subject to IFRS 9:5.4.3[9]. Therefore, the implication is that modifications that are not subject to IFRS 9:5.4.3 are subject to the more general requirements of IFRS 9:B5.4.6.

In the example included in Appendix the borrower will recognise a loss of CU7.97m at the date of modification. In addition, the borrower recalculates its effective interest rate at the date of modification as IFRS 9:B3.3.6 requires that costs or fees incurred in a modification/exchange that is not accounted for an as extinguishment are amortised over the remaining term of the modified liability.

View 2 - do not recognise a gain/loss at the date of modification

When a financial liability is modified or exchanged and is not accounted for as an extinguishment the amortised cost carrying amount at the date of modification/exchange shall only be adjusted to reflect costs or fees incurred as part of that modification/exchange. IFRS 9:B3.3.6 is clear that such fees are not recognised in profit or loss at the date of modification/exchange and instead are amortised in future periods by recalculating the effective interest rate. Consequently, any changes in future cash flows as a result of the modification/exchange are reflected in future periods through the application of the recalculated effective interest rate. Proponents of this view believe that to apply IFRS 9:B5.4.6 in the case of a failed derecognition of a financial liability (as in View 1) and thereby to recognise a gain or loss runs counter to the conclusion that the financial liability has not been extinguished and has merely been modified to terms that are deemed not substantially different.

Proponents of View 2 note that the derecognition requirements for financial liabilities in IAS 39 were modelled based on the U.S. GAAP guidance in effect when the standard was first issued and were intended to be similar. Specifically, the inspiration for the 10 per cent test is found in EITF Issue No. 96-19 (now codified in FASB ASC 470-50). The EITF’s conclusion was that if the original and new debt instruments are not substantially different, then the exchange or modification is not to be accounted for in the same manner as a debt extinguishment. Instead,

[9] IFRS 9:5.4.3 is the new paragraph added to IFRS 9, not previously included in IAS 39, on modification of financial assets.

a new effective interest rate is to be determined based on the carrying amount of the original debt instrument and the revised cash flows.

In the example included in the Appendix to this letter the borrower does not recognise a gain or loss at the date of modification. The borrower recalculates its effective interest rate at the date of modification to reflect the revised contractual cash flows under the modified debt as well as to amortise any costs or fees incurred in the modification in accordance with IFRS 9:B3.3.6.

Reasons for the Committee to address the issue

Modification or exchange of debt instruments is a common practice, particularly when the borrower is in financial difficulty or when market interest rates are low (as is currently the case) and borrowers wish to alter the amount and timing of coupon payments by 'locking in' lower contractual cash flows. The two views presented above lead to very different timing of the recognition of the change in the renegotiated cash flows of the modified borrowing.

The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.

Appendix

Determination of the effective interest rate at initial recognition

Period	0	1	2	3	4	5	6	7
Proceeds	100.00							
Cash coupon payment		(6.00)	(6.00)	(6.00)	(6.00)	(6.00)	(6.00)	(6.00)
Principal								(100.00)
Transaction costs	(2.00)							
	98.00	(6.00)	(6.00)	(6.00)	(6.00)	(6.00)	(6.00)	(106.00)
Effective interest rate	6.36%							

Amortised cost carrying amount (assuming no modification)

Period	1	2	3	4	5	6	7
Opening carrying amount	(98.00)	(98.24)	(98.49)	(98.75)	(99.04)	(99.34)	(99.66)
Interest expense	(6.24)	(6.25)	(6.27)	(6.28)	(6.30)	(6.32)	(6.34)
Cash	6.00	6.00	6.00	6.00	6.00	6.00	106.00
Closing carrying amount	(98.24)	(98.49)	(98.75)	(99.04)	(99.34)	(99.66)	0.00

Modified cash flows based on a modification at the end of period 2

Period	3	4	5	6	7	8	9
Modified cash coupon payment	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)
Modified principal							(130)

Application of the 10% test - old debt

	3	4	5	6	7
Interest	(6.00)	(6.00)	(6.00)	(6.00)	(6.00)
Principal					(100.00)
Total cash flows	(6.00)	(6.00)	(6.00)	(6.00)	106.00
Discount factor at the original EIR	0.94	0.88	0.83	0.78	0.73
Discounted cash flows	(5.64)	(5.30)	(4.99)	(4.69)	(77.87)
Sum of discounted cash flows					(98.49)

Application of the 10% test - new debt

Period	3	4	5	6	7	8	9
Cash coupon payment	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)
Principal							(130.00)
Total cash flows	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	134.00
Discount factor at the original EIR	0.94	0.88	0.83	0.78	0.73	0.69	0.65
Discounted cash flows	(3.76)	(3.54)	(3.32)	(3.13)	(2.94)	(2.76)	(87.01)
Sum of discounted cash flows							(106.46)

Percentage comparison of discounted cash flows of old and new debt

Sum of discounted cash flows for old debt	98.49	
Sum of discounted cash flows for new debt	106.46	
Percentage difference	8.09%	As <10%, no derecognition of old debt

View 1 - recognise a gain/loss at the date of modification

The sum of the estimated contractual cash flows of the new debt discounted by the effective interest rate less the closing carrying value is a gain/loss in profit or loss

Period		3	4	5	6	7	8	9
Estimated contractual cash flows		(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(134.00)
Effective interest rate	6.36%							
Discount factor at the original EIR		0.94	0.88	0.83	0.78	0.73	0.69	0.65
Discounted cash flows		(3.76)	(3.54)	(3.32)	(3.13)	(2.94)	(2.76)	(87.01)
Sum of discounted cash flows								106.46
Less: Previous carrying amount								(98.49)
Difference recognise in profit or loss at the date of modification								7.97

Transaction costs incurred for the modification		(3.00)
Previous carrying amount		98.49
Gain/(loss) on modification		7.97
Transaction costs incurred for the modification		(3.00)
Revised carrying amount		103.46

Solve for a new EIR	103.46	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(134.00)
New EIR	6.84%							

View 2 - do not recognise a gain/loss at the date of modification

A new effective interest rate is determined that discounts the future cash flows to the closing amortised cost carrying amount

Period		3	4	5	6	7	8	9
Previous carrying amount	98.49							
Cash coupon payable		(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)
Principal								(130.00)
Transaction costs	(3.00)							
	95.49	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(4.00)	(134.00)

Effective interest rate 8.21%