STAFF PAPER

July 2017

IASB Meeting

Project	Prepayment Features with Negative Compensation		
Paper topic	Modifications or exchanges of financial liabilities: The IFRS Interpretations Committee's decision		
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Background and objective of the paper

1. The IFRS Interpretations Committee (the Committee) received a request regarding the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. More specifically, the request asked whether, applying IFRS 9 *Financial Instruments*, an entity recognises any adjustment to the amortised cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification or exchange.

2. In March 2017, the Committee tentatively decided not to add this matter to its standard-setting agenda. The tentative agenda decision stated the following:

   (a) The requirements in paragraph B5.4.6 of IFRS 9 apply to 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. This is consistent with the requirements in IFRS 9 for modifications of financial assets that do not result in derecognition, and with the definition of amortised cost in Appendix A of IFRS 9 that applies to both financial assets and financial liabilities.

   (b) An entity applies paragraph B5.4.6 of IFRS 9 to a modification or exchange of a financial liability that does not result in the derecognition of the financial liability. In doing so, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR). The entity recognises any adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange.

(c) IFRS 9 introduced additional wording in paragraph 5.4.3 of IFRS 9 on the accounting for modifications of financial assets. The Committee observed that, if an entity changes its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition as a result of the initial application of IFRS 9, then the entity applies the transition requirements in IFRS 9, which require retrospective application subject to particular relief as specified in Section 7.2 of IFRS 9.

(d) The principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition.

3. The International Accounting Standards Board (the Board) discussed this issue at its February 2017 meeting and agreed with the Committee's technical conclusions on the matter and also concluded that the principles and requirements in IFRS 9 provide an adequate basis to enable an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. The Board concluded that, in this situation, standard-setting is not required and supported an educative agenda decision on the matter, which would explain the accounting required by IFRS 9. However, given the importance of the matter, the Board said it would consider other ways to highlight the relevant accounting.

4. At its June 2017 meeting, the Committee discussed the comments received on the tentative agenda decision published in March 2017. Although agreeing with the technical analysis summarised in the tentative agenda decision, in the light of the comments received, the Committee decided not to finalise the agenda decision and instead referred the matter to the Board.

5. The purpose of this paper is to:

   (a) highlight some of the main concerns raised in the comment letters received on the Committee's tentative agenda decision;

   (b) summarise the Committee's discussion on finalising the agenda decision; and

   (c) suggest a possible solution as to how the Board could confirm the relevant accounting required by IFRS 9.

6. This paper does not contain a question for the Board. Instead, as discussed in Agenda Paper 3, this paper is part of a package of interrelated recommendations related to the finalisation of the amendments to IFRS 9. Therefore, the relevant question is included in Agenda Paper 3C.

Comments on the tentative agenda decision

7. We analysed 13 comment letters on the tentative agenda decision, which have been reproduced in Appendix B to agenda paper 6E for the June 2017 Committee meeting. Paragraphs 9–31 of that paper contain our full analysis of the comments received. The following is a summary of the main concerns raised by respondents and our analysis of those concerns.

Applying paragraph B5.4.6 of IFRS 9 to modifications and exchanges of financial liabilities

8. The tentative agenda decision stated that the requirements in paragraph B5.4.6 of IFRS 9 apply to 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 a financial liability.

9. Some respondents disagreed with that conclusion. They said that an exchange or modification is different from a revision of estimated payments or receipts that occurs according to the original (unmodified) contractual terms of the financial instrument,

and therefore, those two cases should be analysed separately and possibly result in different accounting.

10. Additionally, some respondents said that applying paragraph B5.4.6 of IFRS 9 to a modification of the interest rate charged does not represent the substance of the transaction. In their view, such a change in interest rate reflects a change in the economic characteristics of the liability *in future periods* and would be more faithfully represented by the recognition of an increased or decreased interest expense over the remaining life of the borrowing, rather than by the recognition of an immediate gain or loss. Some respondents said that they think paragraph B5.4.5 of IFRS 9 applies in this case, rather than paragraph B5.4.6.

11. We note that the Committee and the Board discussed the requirements in paragraph B5.4.6 of IFRS 9 at meetings in November 2016 and March 2017, and February 2017, respectively. As set out in the respective Updates, both concluded that those requirements apply to all revisions of estimated payments and receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in derecognition. Applying IFRS 9, an entity remeasures amortised cost by discounting the modified contractual cash flows using the financial instrument's original EIR. We continue to agree with that analysis of the requirements in IFRS 9, and think that respondents have not provided any new information beyond that considered by the Committee and the Board when reaching their conclusions.

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

The treatment of modified cash flows versus costs and fees incurred

13. The tentative agenda decision stated that an entity recognises any adjustment to the amortised cost of a modified financial liability in profit or loss as income or expense at the date of the modification or exchange. In contrast, paragraph B3.3.6 of IFRS 9 requires that any costs and fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the financial liability.

14. Respondents expressed concern about the different accounting treatment for a modification or exchange that does not result in derecognition and any costs and fees incurred. They expressed the view that it could be a problematic distinction to draw and an area where structuring opportunities could arise. Some Committee members shared this concern.

15. We understand the concern raised by respondents about the different accounting treatment. However, we think that the accounting for fees and costs and its interaction with the accounting for modified cash flows are outside the scope of the question submitted. Moreover, we note that the same concern arises when a financial asset is modified. When developing IFRS 9, the Board discussed the accounting for modifications or exchanges of financial assets, and the current requirements in that IFRS Standard reflect the Board’s decisions. If the Board wants to consider changing the existing requirements in IFRS 9 to align the accounting for fees and costs with the accounting for modified cash flows, which would affect both financial assets and financial liabilities, that would require a significantly broader project.

Transition

16. The tentative agenda decision stated that if an entity changes its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition as a result of the entity’s initial application of IFRS 9, then the entity applies the transition requirements in IFRS 9, which require retrospective application subject to particular specified relief.

17. Many respondents requested specific transition provisions for the agenda decision because they think retrospective application may be complex.

18. We acknowledge that retrospective application of paragraph B5.4.6 of IFRS 9 may be complex in some cases. However, we think transition for this matter should be the same as the overall approach for applying IFRS 9 because we do not see a compelling case to provide special transition requirements for only this aspect of the classification and measurement requirements in IFRS 9.

19. Some Committee members expressed the view that there might be insufficient time for an entity to apply retrospectively a change in its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition before the effective date of IFRS 9 (ie annual periods beginning on or after 1 January 2018).

20. We acknowledge those concerns and understand that for some entities the initial application of IFRS 9 is less than six months away. We understand the concern that the transition for this matter could be disruptive to an entity's initial application of IFRS 9. In paragraphs 27–30 below, we suggest how the Board could highlight the relevant accounting required by IFRS 9 related to the matter submitted. We think that suggestion would address some of these concerns expressed about transition.

The appropriate mechanism to address the matter

21. Many respondents expressed concerns about communicating the Committee's conclusion with an agenda decision. They would have preferred an Interpretation or an amendment to IFRS 9. Some respondents said that the requirements in IFRS 9 are not sufficiently clear to result in consistent accounting for the gains and losses arising from modifications and exchanges of financial liabilities that do not result in derecognition. Respondents stated that there is a common understanding in practice that the requirements for liabilities (including any modifications) are largely unchanged between IFRS 9 and IAS 39, and those respondents said that an agenda decision would result in a significant and unexpected change in current accounting practice.

22. Given the widespread impact of the issue and the existence of differing views in practice, the majority of respondents preferred that an authoritative mechanism is used

to implement such a change. Respondents expressed the view that agenda decisions require less due process and generally receive less input from IFRS constituents compared to Interpretations or amendments to IFRS Standards and, as such, agenda decisions tend to receive limited attention and input from preparers. Respondents also said that an authoritative mechanism could reconsider whether specific transition provisions are appropriate or necessary for modifications that occurred before the pronouncement is effective.

23. We understand the background and the concerns that have led respondents to request an authoritative mechanism to address this issue. However, we note that the Board concluded at its February 2017 meeting that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities, and that standard-setting is not required for this matter. In particular, the Board noted that a draft Interpretation, which had initially been proposed by the Committee, would have been used principally as a means of highlighting the accounting already required by IFRS 9. However, the Board acknowledged the importance of this matter and said it will consider other ways to highlight this matter, for example, within a webcast. We think respondents did not provide any new information about the need for standard-setting beyond that considered by the Board at its February 2017 meeting.

The Committee's decision in June 2017 not to finalise the agenda decision

24. At the Committee meeting in June 2017, on the basis of our analysis of the comment letters received, we recommended that the Committee finalise the agenda decision. We also recommended that the agenda decision is supported by other means to highlight the relevant accounting required by IFRS 9.

25. The Committee agreed with the analysis summarised in the tentative agenda decision published in March 2017. However, a number of Committee members had concerns about finalising the agenda decision in light of the comment letters received. Committee members were mainly concerned about transition and structuring opportunities that could arise as a result of the different accounting treatment of a

modification or exchange that does not result in derecognition and any costs and fees incurred. Although the Committee agreed with the technical conclusion, some members expressed the view that an agenda decision would not be an effective mechanism to respond to the question submitted.

26. In accordance with paragraph 5.22 of the IFRS Foundation *Due Process Handbook*, the Committee decided not to finalise the agenda decision and instead referred the matter to the Board.

A possible solution to highlight the relevant accounting

27. As previously described in this paper, the Board discussed this issue in February 2017 and decided that standard-setting is not required because the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities. However, given the importance of the matter, the Board said that it would consider other ways to highlight the relevant accounting required by IFRS 9; for example, in a webcast.

28. We think the feedback from respondents and the Committee confirms the need for such other means. In our view, a webcast could have been an appropriate accompaniment to an agenda decision. While an agenda decision could set out the Committee’s technical conclusions on the relevant principles and requirements in IFRS 9 related to the issue, a webcast could further explain those requirements and their implications. In addition, a webcast could be helpful to raise awareness amongst interested parties about the agenda decision. However, we think that a webcast alone cannot provide the appropriate level of visibility that is required to highlight the relevant accounting required by IFRS 9. Therefore, we think additional means are necessary.

29. As previously explained, we think that respondents did not provide any new information about the need for standard-setting and therefore we continue to agree with the Board’s previous decision that such activity is not required. However, we note that, in April 2017, the IASB published the Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9). The Board is

currently redeliberating these proposed amendments to IFRS 9, and intends to issue any resulting amendments by the end of October 2017. We think this timing could provide an opportunity for the Board to highlight, in a timely manner and without consuming additional resources, the relevant accounting requirements for a modification or exchange of a financial liability that does not result in derecognition. Specifically, we think that the Board could confirm the accounting requirements for this matter in the Basis for Conclusions that will accompany the amendments to IFRS 9. That would be consistent with other observations in the Basis for Conclusions on the Exposure Draft that noted the importance of the requirements in paragraph B5.4.6 of IFRS 9 to account for revisions of estimated contractual cash flows when a financial instrument is measured at amortised cost.

30. There have been instances in the past where the Board took a similar opportunity when finalising amendments to explain the application of other requirements in that IFRS Standard. For example, in April 2016, the Board issued *Clarifications to IFRS 15 Revenue from Contracts with Customers*. During the project that resulted in those amendments, the Board had decided not to amend IFRS 15 for particular issues that had been raised by the IFRS 15 Transition Resource Group. In the Basis for Conclusions on the amendments, the Board discussed its decision not to amend IFRS 15 for those particular issues and, as part of that discussion, also confirmed the relevant accounting requirements.[1]

31. This suggestion, and the related question for the Board, is discussed further in Agenda Paper 3C as part of the package of interrelated recommendations for finalising the amendments to IFRS 9.

[1] For example, the Board decided not to amend IFRS 15 for an issue relating to assessing collectability. In paragraphs BC46B–BC46H of the Basis for Conclusions on IFRS 15, the Board took the opportunity to discuss that decision and, as part of that discussion, explained the relevant accounting requirements.