Project **Derecognition – Financial Liabilities**

Topic **Modification and Extinguishment of Financial Liabilities**

Purpose of this paper

1. This paper addresses the accounting for a ‘substantial modification’ of a financial liability or an exchange of one debt instrument for another debt instrument with ‘substantially different terms’. This issue was raised by many respondents to ED/2009/3 *Derecognition* (ED).

2. For the purpose of this paper, the label ‘substantial modification’ covers both the modification of the terms of a debt instrument and the exchange of one debt instrument for another debt instrument.

Background

3. Consistent with IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39), the ED proposed maintaining a quantitative analysis to determine whether a substantial modification of a debt instrument should be accounted for as an extinguishment of the financial liability associated with the previous debt instrument and the recognition of a new financial liability relating to the modified or new debt instrument. This quantitative analysis is commonly referred to as the ‘10% test’ and is found in paragraphs 39A and AG62 of the ED (paragraphs 40 and AG62 of IAS 39).

4. Respondents asked the Board to confirm whether the ‘10% test’ is an example of a substantial modification, or is the defacto test of a substantial modification.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

5. During the staff outreach it appears as if some take the view that 'substantial modification' occurs only when the 10% test is met. However, others consider that other factors including a change in the currency in which a debt instrument is denominated, a change in a counterparty, or a change of accounting classification (liability vs. equity) also qualify as 'substantial modification'.

6. Some also argue that the '10% test' is an arbitrary rule and question whether it is acceptable to have such a bright line in a principle based financial reporting system.

Contents and scope of this paper

7. This paper sets out
   (a) an analysis of the issue
   (b) a summary of the current requirements and proposals
   (c) four alternatives for determining when a modification of a financial liability should be treated as an extinguishment of the financial liability.

8. The staff is divided on the approach to recommend to the Board. The majority staff view is to recommend Alternative D. Under that alternative, a financial liability is treated as extinguished if the contract evidencing the liability is altered in such a manner that it changes the nature of the investment the original contract represented. Others support Alternative C. Under that alternative, a financial liability is accounted for as being extinguished if the timing, amounts or uncertainty of the cash flows of the debt instrument associated with the existing liability are substantially different from that of the amended debt instrument, or if the nature of the obligation associated with the existing debt instrument has changed. Under both alternatives (assuming the respective extinguishment criteria were met), the entity would recognise a new financial liability.

9. This paper does not deal with 'waivers'. A waiver is an arrangement whereby one party promises not to enforce or promises to relinquish some or all of its rights under a contract but also reserves the power to retract. Although waivers

of fundamental terms are difficult to distinguish from modifications, the staff believes that under such arrangements the promisor does not irrevocably alter the rights of the parties under the original contract and hence the provisions of the original contract subsist.

10. The staff also believes that where the contract contains a clause reserving the right to modify in a specific way, and a modification in that specific manner is within the scope of that clause, the modification would not constitute a creation of a new contract. Amendments in keeping with that specified manner would be seen to have been accomplished in the manner contemplated by and expressly provided for at the time the contract was entered into and thus the effect of such amendments does not result in the creation of a new contract. The parties to the contract were already bound by that provision and the coming into effect of such alterations do not create a new liability.

The Issue addressed in this paper

11. Paragraph 14 of IAS 39 requires recognition of a financial liability when, and only when, an entity becomes a party to the contractual provisions of the instrument (except where the regular way purchase or sale exception applies).

12. Subsequent to entering the contract, the parties may agree to a contractual alteration of the terms of the contract. For example, the contract may be changed to:

    (a) extend or shorten maturity date

    (b) alter subordination provisions and payment priority

    (c) capitalise unpaid interest

    (d) raise or lower interest rates or change the mechanism for determining interest rate

    (e) amend the payment schedule or postpone payments

    (f) increase or reduce principal amounts

    (g) require additional security or partially release security

(h) release a borrower or guarantor from or to liability or add cross default provisions

(i) correct drafting defects or incorrect descriptions

13. The same economic effect can be achieved by making a substantial modification of the terms of an existing contract or by exchanging an existing liability with a new liability. That is, a substantial modification of terms should be approached in the same way as an extinguishment.

14. Of course, the same argument can be made for *any* change in the contractual terms. Hence the question: when, for accounting purposes, are contractual amendments simply a variation of a contract, as opposed to the creation of a new contract?

15. Why is the answer to this question important? The answer may result in an accounting gain or loss. The answer may also have implications for the accounting of the corresponding asset.

16. This question has been answered by considering the extent to which the amended terms change the economic effects arising from the contractual rights and obligations of the contract. It is an extinguishment of the original contract if the amendment results in the economic effects of the original contract being changed significantly. However, a mere variation or modification with no significant economic effect is not considered an extinguishment for accounting purposes. The distinction is hence one of degree. But the question that arises is - at what point does the effects of a contractual modification become significant enough as to constitute a new contract?

Existing requirements and proposals

17. IAS 39 paragraph 40 states that:

'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.'

18. Paragraph AG62 of IAS 39 provides the following guidance to paragraph 40:

    'For the purpose of paragraph 40, 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 percent different from the discounted present value of the remaining cash flows of the original financial liability....'

19. As noted earlier, the ED proposals were identical to IAS 39 paragraphs 40 and AG62 (with some wording clarifications).

20. US GAAP makes a distinction between modifications of the terms of debt instruments for troubled vs. nontroubled debt restructuring transactions.[1] In nontroubled debt restructuring situations, the modification accounting is broadly consistent with IAS 39, albeit US GAAP contains a greater amount of guidance (eg US GAAP provides guidance on additions, deletions or amendments of conversion options in a financial liability contract). However, for troubled debt restructurings, US GAAP is quite different from IAS 39. Generally those requirements (assuming only a modification of terms) would not lead to a full extinguishment of the modified liability.

What constitutes a substantial modification of a financial liability contract?

21. This question is essentially answered today by way of bright-line tests.

22. The staff has set out in the subsequent paragraphs four approaches to determining when an alteration of a contract should be considered as substantial (ie a substantial modification).

23. The staff believes that the assessment as to whether a contract has been substantially being modified should be on contract by contract basis. The staff also believes that it is not logical to assess part of a liability for substantial modification (partial derecognition). For example, in a restructuring of a

[1] See ASC 470-50 and 470-60

contract involving a repayment of part of the outstanding liability and a 'substantial modification' of the contract (technically the part that remains outstanding), it is redundant to treat the transaction as a repayment of part of the liability and then evaluate whether the remaining obligation has been substantially modified. The transaction has resulted in the original liability being replaced with a new liability.

24. Hence, none of the approaches below would allow for partial derecognition of a financial liability on the basis that a part of the contract has been modified. (Note. This conclusion is contrary to the conclusion of the IFRIC in Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*, which does allow for partial derecognition of a financial liability.) The staff believes not allowing for partial derecognition of a financial liability if some of the terms of the debt instrument associated with that liability have been modified is consistent with the wording of IAS 39.40, which states, in part, that:

> *'[…] 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'*. [Emphasis added]

Alternative A – maintain existing requirements of using change in PV of cash flows to make assessment

25. Under Alternative A, a recognised financial liability would be treated as extinguished (and hence should be derecognised) if the contract evidencing the liability is substantially modified. Under this alternative, an alteration of a contract is to be deemed substantial modification if the contract evidencing the liability is altered in such a manner that the present value of the cash flows of the altered contract is at least ten percent different from the present value of the cash flows of the original contract.

26. This alternative is the same as the current guidance in IAS 39. Hence it is familiar to entities applying IFRS. This approach also provides a (relatively) clear cut means of distinguishing alterations to contracts that are substantial from those that are not substantial. It is also consistent with the view that it is

probably not feasible to come up with any valid principle for determining what alteration to a contract is substantial.

27. However, 10% is arbitrary (as would be any other percentage). Some respondents argued that such an arbitrary test is not consistent with a principles based standard or reporting system.

28. Moreover, this alternative is seen by many as providing an incomplete analysis of modification of contracts. For example, a loan contract denominated in US dollars could be changed to being denominated in Russian roubles. Such a change could still meet the 10% test. Many argue that such a change is fundamental and results in the revised loan agreement being substantially different from the original loan agreement.

Alternative B – use change in fair values to make assessment rather than PV of cash flows

29. Under Alternative B, a recognised financial liability would be treated as extinguished (and hence should be derecognised) if the contract evidencing the liability is substantially modified. Under this alternative, an alteration of a contract is to be deemed substantial modification if the contract evidencing the liability is altered in such a manner that the fair value of the altered contract is at least ten percent different from the fair value of the original contract.

30. This alternative has the same advantages and disadvantages as Alternative A (as set out in paragraphs 25 - 28).

31. The major difference however between this approach and Alternative A is that this option would bring the IAS 39 guidance closer to that of US GAAP as this approach would capture additions, deletions or amendments of option features in a financial liability contract. Unlike US GAAP, such amendments are not addressed under IAS 39 and we question whether the present value of cash flows approach in IAS 39 addresses such changes adequately.

Alternative C – use principle-based qualitative and quantitative approach

32. Under Alternative C, a recognised financial liability is treated as extinguished (and hence should be derecognised) if the contract evidencing the liability is substantially modified. Under that approach a contract is substantially modified if:

    (a) the timing, amounts or uncertainty of the cash flows of the original contract are substantially different from that of the amended contract, or

    (b) if the nature of the obligation associated with the original contract has changed.

33. This approach combines a qualitative and perhaps a quantitative approach to determining whether a contract is substantially modified.

34. This approach might require further guidance as to how much change in the amount, timing or uncertainty of cash flows of the instrument is substantial. Some might want to see a quantitative threshold, similar to the 10% threshold in IAS 39 and also as proposed in the ED. The use of quantitative threshold necessarily would require drawing of an arbitrary line, which would also encourage structuring of transactions to specifically circumvent such rules.

35. Under this approach some might view the concept of 'change in the nature of obligation associated with the original contract' differently. Take for example the situation in which a senior loan is subsequently subordinated to other liabilities as a result of amendments to the original contract (or vice versa). The debtor is still obliged to pay the sums borrowed and the interest thereon and possibly on the same payment dates. Therefore the obligation to pay the interest and principal has not changed. However, the staff who support Alternative C would argue that the nature of the obligation has changed (and hence extinguishment accounting should be applied). Other staff (those who support Alternative D) would argue that the nature of the obligation has not changed because the obligation to pay interest and principal remains the same.

Alternative D – principles-based qualitative approach

36. Alternative D addresses the issue of modification primarily from a qualitative standpoint. Under this approach, a recognised financial liability would be treated as extinguished (and hence should be derecognised) if the contract evidencing the liability is substantially modified. The contract is substantially modified if the contract evidencing the liability is altered in such a manner that it changes the nature of the investment the original contract represented.

37. For this purpose, whether a modification is "substantial" would be based on all facts and circumstances and hence would require judgement. The standard would be supplemented with an application guidance of some of the alterations that the Board believes represents a change in the nature of the investment that the contract represents.

38. For example, the following could be included in a list of non-exhaustive examples of when the nature of the investment that the original contract represented is changed:

    (a) A change in the currency in which the principal or interest is denominated

    (b) A change in liquidation preference or ranking of the instrument

    (c) Addition or removal of contingent interest rate or shared appreciation features

    (d) A change from variable interest rate to fixed rate or vice versa

    (e) A change that requires the consent of other class of creditors of the entity

    (f) Addition or deletion of cross collateralisation provisions

    (g) Addition of prepayment provisions or a prepayment premium clauses

39. A difference between this alternative and alternative C is that under this alternative, the test focuses on changes in the nature of the investment the contract represents as opposed to changes in the nature of the obligation.

40. A majority of the staff believes that approach D is more principle based and would address known modification provisions and it is flexible enough to cope with any future contract modification mechanisms.

41. However, this approach will not be attractive to those who prefer a clear cut answer. Also it would require a fact intensive analysis of what constitutes a change in the nature of the investment the contract represents.

42. Obviously, as with all principles that require application of judgement, different entities may arrive at different conclusions in identical scenarios. Hence, this alternative may not enhance comparability of financial statements. Arguably, however, this not necessarily a defect in the principle.

43. Some might argue that this approach requires that the borrower looks to the nature of the investment held by the creditor to assess whether to derecognise a liability or not. As the creditor and the debtor are parties to that specific contract, it suggests that a change in the nature of the investment represented by the contract implies a change in the debtor's liability.

Staff Recommendation

44. **The majority of the staff recommends Alternative D** because they believe that that alternative is the most conceptually appealing option. They also believe that it is the most robust of the alternatives and flexible enough to deal with today's transactions and future developments in debt modification mechanisms.

45. **Some staff prefer Alternative C**. They believe that Alternative D could result in substantial modifications of the amounts and timing of a debt instrument's coupon and principal payments to be accounted for as a modification and not as an extinguishment of the existing financial liability (this is because those changes might not have changed the nature of the investment). They disagree with this outcome.

46. The staff in support of Alternative C acknowledges that that alternative will require judgement and perhaps further application guidance as to what is meant by a 'substantial' modification of the amount, timing or uncertainty of the cash flows of the existing financial liability. However, absent a principle that would treat the modifications of *any* of the terms of a contract that impact the amount, timing or uncertainty of the cash flows provided by that contract, the minority

staff believes that the next best alternative is to provide a threshold for these types of modifications. Finally, the minority staff believes that, in the example in paragraph 35, the nature of the liability has changed as a result of the subordination. The minority staff believes that, absent this conclusion, a similar argument could be made on the asset side in that after the modification, the holder is still entitled to the same interest and principal cash flows, and on the same payment dates.

Question for the Board:
Does the Board agree with the majority staff recommendation in paragraph 44? If not, does the Board agree with the minority view in paragraph 45, and if so, why? If not, which approach would the Board prefer, and why?