Project	**Derecognition**
Topic	**Accounting for extinguishment and modifications of financial liabilities**

Introduction

1. This paper discusses issues arising from:

   (a) modifications of the terms of debt instruments or exchanges of debt instruments for other debt instruments that require extinguishment accounting ('extinguishment accounting')

   (b) modifications of the terms of debt instruments or exchanges of debt instruments for other debt instruments that are *not* accounted for as extinguishments ('modification accounting')

   (c) transactions that require partial extinguishment accounting

   (d) 'debt for equity swap' transactions.

2. Thus, this paper deals with issues relating to the accounting for modifications of terms of debt instruments or exchanges of debt instruments *after* it is determined that these modifications or exchanges require extinguishment accounting or modification accounting. AP 15A discusses *how* such a determination is made.

3. The issues in paragraph 1 are known issues under the derecognition model for financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). However, some respondents to the Exposure Draft (ED/2009/3) *Derecognition* suggested that the Board address these known issues because they have given rise to divergent practice under IAS 39.

Extinguishment accounting

4. Consistent with IAS 39, the ED proposed that an entity account for a substantial modification of a financial liability or an exchange of one debt instrument for another debt instrument with substantially different terms as follows:

   (a) derecognise the liability associated with the previous (unmodified) debt instrument;

   (b) recognise the modified or new debt instrument as new liability and initially measure it at fair value;

   (c) recognise in profit or loss the difference between the carrying amount of the derecognised liability and the consideration paid; and

   (d) include any costs or fees incurred in the profit or loss recognised.

5. Respondents to the ED generally agreed with, or did not object to, the proposed extinguishment accounting.

6. Thus, the staff recommends that the Board confirm this accounting.

7. Some respondents asked the Board to modify the treatment of costs and fees incurred in a transaction that qualifies for extinguishment accounting. Specifically, these respondents indicated that some of the costs and fees incurred might be directly attributable to the issue of the debt instrument associated with the new liability. In this case, the respondents argued that such costs and fees should be allocated to the carrying amount of the new liability and then amortised into profit or loss on the basis of the effective interest rate method.[1]

8. As support for their view, the respondents pointed to the guidance in IAS 39.43 on the initial measurement of a financial liability, which requires a financial liability to be measured initially at fair value *plus* transaction costs that are directly attributable to the issue of the liability.

9. The staff agrees with the respondents that if an entity incurs costs and fees in a transaction that results in extinguishment accounting and necessitates

[1]This assumes that the financial liability was carried at other than at fair value through profit or loss (FVTPL). If the liability was carried at FVTPL, all of the transaction costs incurred in connection with the transaction would be expensed.

recognition of a new liability, it should allocate any directly attributable costs and fees to the new liability, if feasible.

10. However, identifying directly attributable costs in such circumstances could be somewhat arbitrary (eg attorney or auditors' fees might not specify which portion of the fees relates to services for the new liability). This could be of particular concern because attributing such costs to a new liability also affects profit or loss.

11. However, given that the Board is not likely to change the initial measurement of financial liabilities in the near-term and therefore to ensure that the accounting for financial liabilities that are measured in the same way is consistent, **the staff recommends the following approach:**

(a) **An entity shall recognise in profit or loss *all* costs and fees incurred in a transaction that involves a modification of the terms of a debt instrument or an exchange of one debt instrument for another debt instrument and that qualifies for extinguishment accounting *unless* it can identify some of the costs and fees as being attributable directly to the issue of the debt instrument associated with the new liability.**

(b) **If the entity identifies some of the costs and fees as being attributable directly to the issue of the debt instrument associated with the new liability, it shall follow the initial and subsequent measurement guidance in paragraphs 43 and 47 of IAS 39.**

(c) **In making this decision, an entity should consider all relevant facts and circumstances relating to the transaction.**

Question for the Board
Does the Board wish to confirm the accounting set out in paragraph 4 above? If not, what accounting does the Board prefer, and why? Does the Board agree with the approach recommended by the staff in paragraph 11? If not, what alternative treatment does the Board prefer, and why?

Modification accounting

12. Consistent with IAS 39, the ED proposed that an entity account for a modification of a financial liability or an exchange of one debt instrument for another debt instrument with different terms for which extinguishment accounting is **not** allowed as follows:

    (a) continue to recognise the liability associated with the previous (and now modified or exchanged) debt instrument;

    (b) adjust the carrying amount of that liability for any costs or fees incurred; and

    (c) amortise the new carrying amount over the term of the liability.

13. Respondents to the ED generally supported, or did not object to, this guidance in the ED.

14. Thus, the staff recommends that the Board confirm this accounting.

15. Some respondents noted that it was unclear in IAS 39 and the ED whether a new effective interest rate (EIR) would have to be calculated (ie whether the current EIR would have to be updated) in a transaction that requires modification accounting. They asked for clarification on this issue.

Argument for recalculation of EIR

16. If an entity enters into a transaction that involves the modification of the terms of a debt instrument or the exchange of one debt instrument for another debt instruments and that fails extinguishment accounting, it is precluded from derecognising the financial liability associated with the previous debt instrument. Thus, some argue that as a matter of general principle the entity should not recognise a gain or loss on this transaction.

17. In order *not* to recognise any gain or loss on the transaction, the entity would have to keep the carrying amount of the liability unchanged after the modification. To achieve this, the entity would have to adjust the EIR (the denominator) because after the modification the liability has different cash flows from those under the original terms (the numerator).

Arguments against recalculation of EIR

18. However, an approach requiring recalculation of the EIR contradicts the guidance in paragraph AG 8 of IAS 39.[2] If an entity revises its estimates of the payments on a recognised financial liability, paragraph AG8 of IAS 39 requires it to adjust the carrying amount of that liability using the *original* EIR to reflect the revised estimated cash flows. The entity recognises the adjustment of the carrying amount of the liability in profit or loss.

19. Paragraph BC36 of IAS 39 explains that this approach has the practical advantage that it does not require recalculation of the EIR; that is, the entity simply recognises the remaining cash flows at the original rate. Paragraph BC36 further explains that this approach avoids a possible conflict with the requirement when assessing impairment to discount estimated cash flows using the original EIR.

20. The Exposure Draft (ED/2009/12) *Financial Instruments: Amortised Cost and Impairment*, issued in November 2009, is consistent with the guidance in AG 8 of IAS 39 in that it proposes to use the initial (ie original) EIR over the life of the instrument (see paragraphs B2 and B14).[3]

21. Recalculating the EIR might also result in negative interest over the remaining term of the modified debt. This phenomenon could occur if the gain on the modification that otherwise would be recognised in profit or loss on the date of that modification is so large that by including it in the EIR and then amortising it as part of the revised EIR into profit or loss over the remaining term of the modified debt, the EIR becomes negative. Those who do not support recalculating the EIR in a transaction that qualifies for modification accounting believe that recognising negative interest on a debt instrument defies commercial logic.

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[2]Note that paragraph AG7 of IAS 39 requires that for floating-rate financial assets and liabilities the EIR be recalculated if the interest cash flows of the financial instrument are reset due to the contractual provisions of that instrument. Similar guidance can be found in paragraph B12 of the Exposure Draft (ED/2009/12) *Financial Instruments: Amortised Cost and Impairment*. The staff notes that recalculation of the EIR as a result of (pre-existing) contractual resets of the interest cash flows is different from the issue of whether to recalculate the EIR as a result of a modification of the terms of the contract associated with the debt instrument.

[3]See footnote 2.

22. Some would also argue that the nature of the gain or loss that an entity recognises in a transaction that qualifies for modification accounting is different from the nature of the gain or loss the entity recognises in a transaction that qualifies for extinguishment accounting. The extinguishment gain or loss is the result of a transaction that leads to the derecognition of a financial liability; the modification gain or loss is the result of a transaction that leads to changes in the expected cash flows over the remaining life of a recognised financial liability. Those changes are similar to changes in estimates in relation to financial assets and financial liabilities that are measured at amortised cost, which under the *Impairment* ED are treated as gains or losses, and not as interest revenue and interest expense, respectively

Staff recommendation

23. **A majority of the staff recommends that an entity should recognise the gain or loss in a transaction that qualifies for modification accounting immediately into profit or loss, and *not* include the gain or loss as part of an adjustment to the EIR over the remaining term of the modified financial liability.** Those staff members are of this view for the reasons given in paragraphs 18-22.

24. A minority of the staff believes that, for the reason cited in paragraphs 16-17, the EIR should be recalculated so that gains or losses are not recognised in transactions that qualify for modification accounting. The majority of the staff note that this would represent an exception to paragraph AG8 of IAS 39, and the proposals in (ED/2009/12) *Financial Instruments: Amortised Cost and Impairment.*

Question for the Board
Does the Board wish to confirm the accounting set out in paragraph 12 above? If not, what accounting does the Board prefer, and why? Does the Board agree with the staff recommendation in paragraph 23? If not, does the Board prefer the view expressed in paragraph 24, and if so, why?

Partial extinguishment accounting

25. The following paragraphs deal with partial extinguishments in the context of an entity *repurchasing* a part of a financial liability. The paragraphs do not deal with transactions that *combine* a repurchase of part of a financial liability and a modification of some of the terms of the debt instrument associated with that liability. AP 15A addresses these types of transactions.

26. Consistent with IAS 39, the ED proposed that if an entity derecognised a part of financial liability, it would allocate the previous carrying amount of the liability between the part that it continued to recognise and the part that it derecognised according to the relative fair values of those parts on the date of derecogntion. The entity would recognise in profit or loss the difference between

    (a) the carrying amount allocated to the part derecognised and

    (b) the consideration paid for the part derecognised.

27. Respondents to the ED generally supported, or did not object to, the partial extinguishment guidance proposed in the ED.

28. Thus, the staff recommends that the Board confirm this accounting (as set out in paragraph 25, this is in the context of an entity repurchasing a part of its financial liability).

Question for the Board
Does the Board agree with the staff recommendation in paragraph 28? If not, why not, and what would the Board prefer instead, and why?

'Debt for equity swap' transactions

29. A debtor and creditor sometimes renegotiate the terms of a financial liability and the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are referred to as 'debt for equity swaps'.

30. It is clear that debt for equity swap transactions qualify for derecognition of the liability. However, some respondents noted that IAS 39 and the ED were not

clear on whether any gains or losses should be recognised on these transactions. They suggested that the Board address this issue as part of the derecognition project in revisiting the requirements for derecognising a financial liability.

31. This issue is addressed in IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments*. This is an interpretation of IAS 39 and IAS 32 *Financial Instruments: Presentation*.

The issue and IFRIC's consensus

32. The respondents to the ED asked the Board to clarify whether any gains or losses should be recognised on debt for equity swaps under IAS 39, mainly because it is not clear how an entity initially measure equity instruments issued to extinguish a financial liability.

33. IFRIC 19 addresses the following two[4] issues in answering this question.

    (a) Do an entity's equity instruments issued to extinguish a financial liability qualify as 'consideration paid'?

    (b) How should an entity initially measure the equity instruments and account for any difference between the carrying amount of the liability extinguished and the initial measurement amount of the equity issued?

(a) Consideration paid

34. Both IAS 39 (paragraph 41) and the ED (paragraphs 41A and 42B) require that an entity recognise in profit or loss the difference between the carrying amount of the extinguished financial liability and the 'consideration paid' for it. IAS 39 and the ED specifically refer to 'non-cash assets transferred' and 'liabilities assumed' as an example included in the consideration paid, but are silent on whether equity instruments an entity issues to extinguish its financial liability qualify as the consideration paid.

35. IFRIC 19 concludes that the issue of equity instruments is consideration paid, observing that both IFRS 2 *Share-based Payment* and IFRS 3 *Business*

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[4] IFRIC 19 addresses three issues. However, the staff combined the second and third issue because they are closely related with each other.

Combinations make it clear that equity instruments are used as consideration to acquire goods and services as well as to obtain control of business.

(b) Initial measurement of equity instruments and accounting for the difference from the carrying amount of the extinguished liability

36. IFRSs do not contain a general principle for initial recognition and measurement of equity instruments. Some of the respondents to the ED were concerned that there were divergent views on whether the issue of equity as extinguishment of a financial liability should be at fair value of the equity instruments or the carrying amount of the extinguished liability.

37. Some are of the view that it should be at fair value and thus the difference between the carrying amount the liability extinguished and the fair value of the equity instruments issued should be recognised as gains or losses on the transaction.

38. They argue that it is consistent with the accounting treatment for a transaction where a new financial liability is recognised as a result of extinguishment of an existing liability (ie 'debt for debt'). IAS 39 is clear on initial measurement of a financial liability and explicitly requires that an entity should measure a financial liability initially at fair value (paragraph 43). Therefore, it is obvious that the difference between the carrying amount of the old liability and the fair value of the new liability is recognised as a gain or loss in the case of 'debt for debt' swap.

39. However, others argue that the equity issued should be measured at carrying amount of the extinguished liability and thus no gains or losses should be recognised because IAS 39 and IFRSs in general do not specify how equity instruments should be initially measured.

40. IFRIC 19 concludes that the fair value of the equity instruments issued should be used[5] and that the difference between the fair value of the equity instruments

[5] IFRIC 19 further explains that if the fair value of the equity instruments issued is not reliably determinable, then the fair value of the liability extinguished is used for initial measurement of the equity instruments.

and the carrying amount of the extinguished liability should be recognised as a gain or loss.

Staff recommendation

41. The staff agrees with the IFRIC's consensus that equity instruments issued to extinguish a financial liability should be included in the consideration paid.

42. The staff also agrees that that any difference between the carrying amount of the extinguished liability and the fair value of the consideration paid should be recognised as a gain or loss, regardless of whether the consideration paid is a financial liability or an equity instrument. However, the staff would like to clarify that, consistent with IAS 39.AG64, to the extent the fair value of the consideration paid differs from the fair value of the extinguished liability, part of the consideration given or received is for something other than the extinguishment of the liability. If this 'something else' qualified for recognition of an asset or a liability, it would impact the gain or loss recognised.

43. Therefore, the staff recommends that the next due process document for the derecognition project incorporates the following points, which are all consistent with the consensus reached in IFRIC 19:

(a) Equity instruments issued to extinguish a financial liability should be included in 'consideration paid'.

(b) Equity instruments should be initially measured at fair value when issued to extinguish a financial liability.

(c) The difference between the carrying amount of the extinguished liability and the fair value of equity instruments issued, less any assets acquired or liabilities assumed in connection with the transaction, should be recognised as gains or losses.

Question for the Board
Does the Board agree with the staff recommendation in paragraph 43? If not, what approach does the Board prefer, and why?