Project	**Derecognition**
Topic	**Knock-on effects of symmetry and extinguishment accounting**

Contents and purpose of this paper

1. In the December 2009 Board meeting the staff indicated that when a substantial modification leads to the extinguishment of a financial liability, there is a need for symmetry in derecognition accounting for the related financial asset (December 2009 paper AP15C). The staff also noted that symmetry in derecognition could have some implications for the IFRS 9 *Financial Instruments* project. However, at the December 2009 meeting the staff requested that the Board only consider symmetry in the context of derecognition.

2. The Board tentatively agreed that if an amendment to a contract meets the substantial modification criteria for extinguishment of a liability (December 2009 paper 15A), derecognition accounting should be symmetrical for both the borrower and the lender.

3. As a follow up to the December discussions, this paper addresses possible implications for the IFRS 9 project.

4. Unless the Board has questions on this topic, the staff does not plan to further discuss this paper.

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.

Issue

5. At the December 2009 Board meeting, the Board concluded that if a financial liability is substantially modified and therefore considered extinguished, the old liability should be derecognised and a new liability recorded (initially at fair value).

6. As noted in paragraph 2, at that meeting the Board also decided that there should be symmetry in the derecognition requirements for financial assets and liabilities. This means that when there is a substantial modification to a financial liability which results in extinguishment (derecognition) of the original liability and recognition of a new liability, the holder of the related financial asset should also derecognise the old asset and recognise a new financial asset (initially at fair value). Note that this paper is only referring to substantial modifications leading to derecognition of a financial liability and the related financial asset.

7. The effects of the proposed symmetry in derecognition could be seen as being similar to:

    (a) a quasi fair-value based impairment for assets measured at amortised cost; or

    (b) allowing or requiring reclassification of a financial asset without a change in business model.

Staff analysis

Impairment

8. Under current guidance[1], if there is objective evidence that an impairment loss on financial assets measured at amortised cost has occurred, an entity shall calculate and record an impairment loss. Objective evidence includes significant financial difficulty of the debtor (an 'incurred' loss event). Often entities may

[1] IAS 39, *Financial Instruments: Recognition and Measurement*, paragraphs 58-70 (as amended by IFRS 9)

agree to substantially modify the terms of an instrument due to such financial difficulties. As a result, if the terms of a financial instrument [measured at amortised cost] are renegotiated or otherwise modified because of financial difficulties of the debtor, an impairment loss is considered to have been incurred. The loss is measured using the expected future cash flows as a result of the 'incurred' loss event discounted at the original effective interest rate[2], and is included in profit or loss.

9. Under the proposed guidance in **ED /2009/12** *Financial Instruments: Amortised Cost and Impairment*, the carrying amount of an amortised cost instrument is calculated by discounting the expected cash flows over the remaining life of the instrument at the original effective interest rate, with changes in the carrying amount recognised in profit or loss. Hence the carrying amount of the asset changes if there are revisions to the expected future cash flows, irrespective of there being an 'incurred' loss event.

10. Based on the December 2009 decision of the Board, substantial modifications to the terms of an instrument require the financial liability and related financial asset to be derecognised, and new instruments to be recognised (initially at fair value). Compare that to existing requirements for financial assets (measured at amortised cost). Today the asset is either impaired and/or re-measured using the effective interest method under IAS 39 paragraph AG8.

11. Symmetry in derecognition will result in different calculations of gains and losses for financial assets measured at amortised cost depending on whether the modifications are considered substantial. Following are examples of the results under the current versus the proposed guidance when modifications to terms are made under a recovery strategy. These examples only apply to financial assets and liabilities measured at amortised cost.

[2] IAS 39 paragraph AG84 (as amended by IFRS 9)

a) The holder of a debt instrument amends the subordination provisions in the contract such that the instrument is no longer ranking in seniority to other creditors. The amendment is intended to facilitate a recovery strategy for repayment of the amounts owed.

Current guidance

This **would not** qualify as a substantial modification to the instrument as this is not a quantitative change to the cash flows owed under the actual financial liability[3]. In addition, the debtor would not recognise a gain or loss. If considered a loss event, the holder of the asset would modify the expected cash flows and record an impairment loss based on the original effective interest rate only.

Proposed guidance

This **would** be a substantial modification as it changes the nature of the investment. Symmetry as discussed herein would result in derecognition and re-recognition at fair value of both the financial asset and liability. The debtor would recognise a fair value gain which includes changes in its own credit. The creditor would recognise a loss that would include the incremental fair value changes not previously considered when measuring the expected cash flow changes (including impairment) of the asset.

[3] Under IAS 39 paragraph 40 a substantial modification of the terms of a financial liability shall be accounted for as an extinguishment of the original and recognition of a new liability. Paragraph AG 62 indicates that *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 debt instruments or modification of the remaining cash flows of the original financial liability.*

b) The holder of a debt instrument agrees to defer the due date of cash flows to ensure the debtor has the ability to repay the loan. The loan continues to accrue interest in the interim.

Current guidance

If the substantial derecognition criteria under IAS 39 are met, the liability would be extinguished, and a gain or loss would be recognised on extinguishment. A new liability would be recognised initially at fair value. The holder of the asset would not derecognise the asset but would modify the expected cash flows and discount them using the original effective interest rate (whether as impairment loss and/or due to applying paragraph AG8 of IAS 39).

If the substantial derecognition criteria under IAS 39 are not met, there will be no extinguishment of the liability and no gain or loss recorded. The carrying amount of the asset will be adjusted for changes in expected cash flows resulting in a possible impairment loss.

Proposed guidance

Assuming the delay in requiring repayment under the debt agreement **results in a substantial modification**, under symmetry in derecognition both the asset and liability would be derecognised. The new instruments will be initially measured at fair value. Any gain/loss on the original amortised cost liability will be based on its fair value at extinguishment. Any gain/loss on the amortised cost asset will be the difference between its fair value and present value of the expected cash flows discounted using the original effective interest rate (i.e. amortised cost on derecognition).

c) The holder of a financial asset waives a significant portion of the nominal amount in order to facilitate a recovery of some of the amounts loaned.

Current guidance

If the substantial derecognition criteria are not met, there will be no extinguishment of the liability and no gain or loss recorded. The carrying amount of the asset will be adjusted for changes in expected cash flows resulting in a possible impairment loss.

If the substantial derecognition criteria are met, the liability would be extinguished, and a gain or loss would be recognised on extinguishment. A new liability would be recognised initially at fair value. On the asset side, the holder of the asset would not derecognise the asset. It would, however, modify the expected cash flows and discount them using original effective interest rate (whether an impairment loss and/or due to applying paragraph AG8 of IAS 39).

Proposed guidance

This **would be a substantial modification** resulting in derecognition of both the asset and liability. Note that this is not a partial derecognition as a portion of the liability was not repaid. The new instruments will be initially measured at fair value. Gains or losses on the original amortised cost liability will be based on its fair value at extinguishment. Gains or losses on the amortised cost asset will again be the difference between fair value and present value of the expected cash flows discounted using the original effective interest rate (i.e. amortised cost on derecognition).

12. The discussion in paragraph 11 raises the question as to whether symmetry in derecognition is effectively providing a quasi - fair value based impairment model in particular circumstances. In the past, the Board discussed and rejected a fair-value based impairment model for the new amortised cost category of IFRS 9[4]. The reasons for the rejection included:

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[4] **Basis for Conclusions on ED /2009/12** *Financial Instruments: Amortised Cost and Impairment* paragraphs BC15 –BC21

(a) There would no longer be a relationship between either the measurement basis for revenue recognition and interest revenue, or between the carrying amount of the financial asset and interest revenue (e.g. the discount rate that reconciles expected cash flows with the carrying amount of the asset would no longer be the effective interest rate, which is incompatible with the amortised cost approach)

(b) Concern over having a mixed- measurement model for a single measurement category (i.e. amortised cost)

(c) Concern that an impairment approach based on fair value would require fair value accounting on a contingent basis. In BC20, the Board noted that after impairment on a fair value basis, either the fair value at that point in time would have to be used as a deemed cost basis or the non-credit related portion of the fair value changes would have to be amortised separately

13. The staff, after considering the above concerns, believes that the Board should distinguish between impairment of an existing asset, and the recognition of a new asset. Once an entity is required to derecognise a financial asset because of a substantial modification to the related liability, the old asset no longer exists and a new asset should be recognised. The realisation of any gain or loss on an extinguishment of an instrument should also be distinguished from the measurement of a credit loss (under impairment accounting) for the same instrument.

14. Extinguishment of the old and recognition of a new asset is not intended to imply that an asset is impaired, nor is it intended to imply that the same asset should be measured on a different basis. While symmetry in derecognition will result in a different measurement of gains or losses for assets and liabilities than under the current (and proposed impairment/amortised cost) guidance, symmetry in derecognition is not a measurement issue. It is about what assets and liabilities an entity has at the reporting date. Measurement (including impairment) of the financial assets and liabilities that an entity has at the reporting date is addressed in the other ongoing financial instrument projects.

15. Symmetry in derecognition (i.e. recognition of a new financial asset upon substantial modification and extinguishment) also meets the recognition guidance under IFRS 9, paragraph 3.1.1, which indicates that "*an entity shall recognise a financial asset in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.*" When an entity has modified the terms of an instrument to the extent that it must be derecognised, it goes on to recognise a new asset because it has become a party to the contractual provisions of a new financial asset.

Reclassification

16. As noted in paragraph 5 of this paper, symmetry in derecognition means that substantial modifications to a financial liability from the holder's point of view (e.g. the financial asset) would result in derecognition of the original financial asset and recognition of a new financial asset at fair value on that date. Once a new asset is recognised, the possibility exists for it to be classified differently than the asset that was previously held if, for example, the cash flow characteristics of the "new" asset are different from the cash flow characteristics of the "old" asset.

17. IFRS 9 paragraph 4.1 indicates that assets shall be measured at amortised cost or fair value on the basis of both a) the entity's business model for managing the assets and b) the contractual cash flow characteristics of the asset.

18. IFRS 9 paragraph 4.9 prohibits reclassifications of financial assets between amortised cost and fair value unless there is a change in business model. If there is a change in business model, reclassification is <u>required</u> under IFRS 9.

19. As noted in paragraph 10, under IFRS 9 a modification of terms that doesn't result in derecognition would be measured using the effective interest method. IFRS 9 doesn't permit reclassification due to a modification in terms. In developing IFRS 9 the Board considered allowing reclassifications when contractual cash flows vary over the life of the asset based on the original contract terms. However, the Board rejected this based on the fact that contractual terms are known at the inception of the asset and that an entity

should classify an asset based on the original contractual terms over the life of the asset.

20. Absent requirements triggering derecognition upon a modification of terms (for which there currently is no specific guidance currently under IAS 39), the classification of a financial asset, assuming the same business model, could not change. However, some may believe that the symmetry in derecognition has the same effect as a reclassification of the original financial asset (via derecognition and re-recognition) due to substantial modifications to terms of the instrument. If this is the case, this would be contrary to the requirements of IFRS 9.

21. The IFRS 9 classification and measurement team note that if there is a point when a change in terms should result in derecognition and potentially a different classification on "re-recognition", IFRS 9 is reliant on the derecognition project to introduce this. Finally, the staff believes that symmetry in derecognition does not contradict the requirements under IFRS 9. Again, this is simply because a new asset with potentially new characteristics of cash flows is being recognised and therefore the old one is not considered to be reclassified.