Accounting for debt restructuring under the new IFRS 9

Is it still possible to avoid a profit or loss impact at the restructuring date?

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The new standard IFRS 9 on the accounting of financial instruments, effective from 1 January 2018, removes one of the widely used accounting treatments for debt restructuring transactions previously allowed under the old standard IAS 39. The new requirements force entities to record an immediate profit or loss impact as at restructuring date. We recommend evaluating this potential impact on transition to IFRS 9.

It is common for an entity, when facing cash flow problems or when observing advantageous conditions in capital markets, to approach its creditors for a restructuring of its debt commitments. A restructuring can be done in different ways but one of the approaches most often used is to change the terms of debt, for example, by postponing the repayment of the principal in exchange for higher/lower interest payments (often referred to as a debt modification) or by replacing the original loan with a new loan with the same lender with different economic terms (often referred to as a debt exchange).

When replacing an existing debt with a new debt from a new lender, the existing debt would be de-recognized in the financial statements, with the difference between the carrying amount and the fair value of the consideration paid recognized in profit or loss. However, when modifying or exchanging a debt while keeping the original lender, the International Financial Reporting Standards (IFRS) have specific guidance on whether the transaction results in a de-recognition or is accounted for differently. This analysis is driven by the question whether the modification is "substantial" or whether the original debt has been replaced by another debt with "substantially" different terms.

The term "substantial" as such is very subjective. However, IFRS assumes that a change is substantial if one of the two following tests are met:

- Quantitative test: the net present value of the cash flows under the new terms discounted at the original effective interest rate is at least 10% different from the carrying amount of the original debt. This test is commonly referred to as the "10% test".
- Qualitative test: A significant change in the terms and conditions that is so fundamental that immediate de-recognition is required with no additional quantitative analysis (e.g., new debt having a different currency to the old debt, equity instrument embedded in the new debt, etc.).

A "substantial" debt modification or a debt exchange with "substantially" different terms is accounted for as an extinguishment of the original financial liability. This results in de-recognition of the original loan and the recognition of a new financial liability at its fair value. This results in a direct impact on profit or loss due to the difference between the carrying amount of the original financial liability and the fair value of the new financial liability (taking also into account any cash consideration paid or non-cash assets transferred).

If the above analysis results in the conclusion that a debt exchange or modification is considered as not substantial, the question is how an entity should account for changes to the future (now modified) contractual cash flows?

The old accounting standard IAS 39 Financial Instruments: Recognition and Measurement did not provide a conclusive answer to this question. In practice, entities could choose between the following two alternatives:

a) The net present value of changes to the future contractual cash flows is amortised over the remaining term of the (modified) liability. This approach does not result in any immediate profit or loss impact at the restructuring date as the effect is distributed over the remaining lifetime of the new debt. Hence, this was the approach most commonly applied in practice.

a) The net present value of changes to the future contractual cash flows adjusts the carrying amount of the original debt with the difference immediately recognised in profit or loss. The adjusted carrying amount is then amortised over the remaining term of the (modified) liability using the original effective interest rate.

These two alternatives are illustrated below with a simple example where both interest rate and payment dates of an original loan have been (not substantially) modified in year 3:

Original Debt

Interest	*5%*	(fixed and paid annually)	
Notional	*100*		
Maturity	*Year 5*		

Year	Cash flow	Book value at restructuring date	
0	100		
1	-5		
2	-5		
(Restruct. date) 3	*-5*	-100	a
4	-5		
5	-105		

Quantitative test (b/a - 1)	7.61%	< 10%
Net present value of changes to the future contractual cash flows (b - a)		-7.61

New Debt

Interest	*6.5%*	(fixed and paid annually)	
Notional	*100*		
Maturity	*Year 8*		

Year	Cash flow	Discount factor (original effective interest rate)	Present value	
0				
1				
2				
(Restruct. date) 3	*-6.5*	$1/1.05^{1}$	-6.19	
4	-6.5	$1/1.05^{2}$	-5.90	
5	-6.5	$1/1.05^{3}$	-5.61	
6	-6.5	$1/1.05^{4}$	-5.35	
7	-6.5	$1/1.05^{5}$	-5.09	
8	-106.5	$1/1.05^{6}$	-79.47	
			-107.61	b

The result obtained in the quantitative test (7.61%) shows that the debt was not substantially modified as it is below the 10% hurdle. The debt was also not substantially modified based on the qualitative test. Hence, depending on the accounting policy choice followed, the entity could:

a) maintain the carrying amount at 100 and adjust the effective interest rate applied to the modified debt from restructuring date on, that is, apply 6.5% instead of 5% and therefore the 7.61 loss will be amortized over the remaining term of the debt (year 8); or

b) Immediately account for a modification loss of 7.61 in profit or loss at the restructuring date, adjusting the book value of the debt to 107.61 and keep applying the original effective interest rate of 5%.

However, under the new standard IFRS 9 Financial Instruments, applicable for accounting periods beginning on or after 1 January 2018, option a) above is no longer permitted. Further, IFRS 9 has to be applied retrospectively at first time adoption. For an entity applying IFRS 9 for the first time in its 2018 annual financial statements, any effect of applying the above new requirement has to be accounted for in retained earnings as of 1 January 2018. Obviously, applying the new IFRS 9 would only result in such an effect to retained earnings if an entity:

a) had debt restructurings in the past on debt still recognized as at 1 January 2018; and

b) applied the now no longer permitted option a) above to the modification.

Affected entities are required to perform a thorough analysis that should not be underestimated.

Learn more

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