IFRS

STAFF PAPER

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IASB Meeting

Project	**IFRS 9 *Financial Instruments*: Modification or exchange of financial liabilities**
Paper topic	Interpretations Committee tentative decisions

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Introduction and objective of the paper

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request regarding IFRS 9 *Financial Instruments*. The request asked the Interpretations Committee to clarify whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in the derecognition of the financial liability.

2. The Interpretations Committee discussed the issue at its November 2016 meeting (see Agenda Paper 6). At that meeting, the Interpretations Committee tentatively decided to develop a draft Interpretation, which would explain the accounting for such modifications and exchanges.

3. The objective of this paper is to provide the International Accounting Standards Board (the Board) with background to the issue, and a summary of the discussions at the Interpretations Committee meeting. In accordance with paragraph 7.10 of the *Due Process Handbook*, we are asking Board members whether they object to the release of a draft Interpretation.

Structure of the paper

4. The paper is organised as follows:

   (a) the submission and feedback from outreach (paragraphs 5–7);

   (b) what the requirements in IFRS 9 say (paragraphs 8–11);

   (c) the Interpretations Committee's conclusion on the application of IFRS 9 (paragraphs 12–14); and

   (d) the Interpretations Committee's decision to develop a draft Interpretation (paragraphs 15–20).

The submission and feedback from outreach

5. The submitter asked whether, in applying IFRS 9, an entity recognises a gain or loss in profit or loss when a financial liability measured at amortised cost:

   (a) is modified or exchanged; and

   (b) that modification or exchange does not result in the derecognition of the financial liability.

6. The submitter identified two views:

   (a) **View One**: an entity re-estimates the contractual cash flows but does not change the original effective interest rate (EIR). At the date of the modification, the entity recognises any adjustment to the carrying amount of the financial liability resulting from re-estimating the contractual cash flows (discounted at the original EIR) as a gain or loss in profit or loss.

   (b) **View Two**: an entity does not recognise a gain or loss in profit or loss at the date of the modification. Instead, it re-calculates the EIR at the date of the modification as well as re-estimating the contractual cash flows. As a consequence, the entity amortises any gain or loss over the remaining term of the modified liability in the same way as costs and fees incurred as part of the modification.

7. Outreach conducted revealed that View Two is the most commonly observed approach applying IAS 39 *Financial Instruments: Recognition and Measurement*. Because the requirements in IFRS 9 on modifications of financial liabilities were carried forward largely unchanged from IAS 39, many respondents to the outreach indicated that they expect practice to remain the same applying IFRS 9. However, other respondents observed that changes made to the requirements in paragraph B5.4.6 of IFRS 9 and the new requirements on modifications of financial assets in paragraph 5.4.3 of IFRS 9 could be read to imply that View One is the appropriate answer applying IFRS 9.[1]

What the requirements in IFRS 9 say

8. IFRS 9 describes amortised cost as 'a relatively simple measurement technique that allocates interest over the relevant time period using the effective interest rate.'[2] Appendix A of IFRS 9 includes a single definition of amortised cost that applies to both financial assets and financial liabilities—'amortised cost of a financial asset or financial liability' is defined as:

> The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

9. In the case of a financial liability, the EIR discounts estimated future cash flows through the expected life of the financial liability to its amortised cost. Appendix A of IFRS 9 defines the 'effective interest rate' as:

> The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying

[1] Paragraphs 5.4.3 and B5.4.6 of IFRS 9 are reproduced below in paragraphs 10 and 11 of this paper.

[2] See paragraph BC4.158 of IFRS 9.

> amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. […]

10. Paragraph 5.4.3 of IFRS 9 says the following regarding modifications of contractual cash flows for financial *assets* measured at amortised cost:

> When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.

11. Paragraph B5.4.6 of IFRS 9 says the following regarding amortised cost measurement for both financial assets and financial liabilities:

> If an entity revises its estimates of payments or receipts (excluding modifications in accordance with

paragraph 5.4.3 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. The adjustment is recognised in profit or loss as income or expense.

The Interpretations Committee's conclusions on the application of IFRS 9

12. The Interpretations Committee concluded 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 modifications or exchanges of financial liabilities that do not result in derecognition of the financial liability. The Interpretations Committee noted that this is consistent with the requirements in paragraph 5.4.3 of IFRS 9 relating to modifications of the contractual cash flows of a financial asset that do not result in derecognition, and the definition of amortised cost in Appendix A of IFRS 9. In addition, in the case of a modification or exchange of a financial liability that does not result in derecognition, the financial liability continues to be accounted for as the same financial liability.

13. The Interpretations Committee concluded that, applying paragraph B5.4.6 of IFRS 9 to such modifications or exchanges of financial liabilities, an entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original 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. Accordingly, the Interpretations Committee agreed with View One in the submission.

14. The Interpretations Committee observed that the feedback from outreach activities on practice applying IAS 39 indicated it would be beneficial to clarify the accounting required by IFRS 9 for modifications or exchanges of financial liabilities that do not result in derecognition. Consequently, the Interpretations Committee tentatively decided to develop a draft Interpretation, which would explain the accounting for such modifications and exchanges.

The Interpretations Committee's decision to develop a draft Interpretation

15. The Interpretations Committee's discussion at its November 2016 meeting focused on whether it would be necessary to add to or change IFRS Standards to improve financial reporting. In other words, the Interpretations Committee discussed whether the principles and requirements in IFRS 9 provide an adequate basis to enable an entity to account for modifications or exchanges of financial liabilities that do not result in derecognition:

    (a) If the principles and requirements provide an adequate basis, a standard-setting project would *not* be added to the work plan. Instead, the Interpretations Committee would issue an educative Agenda Decision, which would include the Interpretations Committee's conclusions and references to the relevant principles and requirements in IFRS 9.

    (b) If the principles and requirements do not provide an adequate basis, a standard-setting project would be added if the Interpretations Committee concluded that the Board or Committee could resolve the issue effectively by issuing an Interpretation or a narrow-scope amendment to the Standards.

16. The staff had recommended issuing an Agenda Decision on the grounds 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.

17. Some Interpretations Committee members supported issuing an Agenda Decision for the same reasons as those of the staff. They highlighted the definition of amortised cost in IFRS 9, which is the same for both financial assets and financial liabilities, and also the new requirements for modifications of financial assets in paragraph 5.4.3 of IFRS 9. In their view, standard setting is not required. An educative Agenda Decision would provide clarity on the matter, and would be expected to do so within a relatively short time period, before the effective date of IFRS 9 (ie 1 January 2018). It would not be possible to finalise a standard-setting project with an effective date of 1 January 2018.

18. The majority of Interpretations Committee members, however, expressed concerns about issuing only a non-authoritative Agenda Decision on this matter. In the light of the outreach responses regarding practice applying IAS 39 (confirmed by Interpretations Committee members' own experience in practice), they were concerned that many entities would be unaware of the conclusions reached by the Interpretations Committee, and thus unaware that they may need to change their existing accounting for such modifications when they first apply IFRS 9. Those members highlighted the prevalence of such modifications in practice. They thought that greater prominence should be given to this matter than would be the case if the Interpretations Committee issued only an Agenda Decision. It was noted that while IFRS 9 now explicitly specifies the accounting for modifications of financial assets that do not result in derecognition, IFRS 9 does not explicitly specify the accounting for modifications of financial liabilities that do not result in derecognition.

19. Consequently, the Interpretations Committee tentatively decided to develop a draft Interpretation. The draft Interpretation would specify the accounting for modifications or exchanges of financial liabilities that do not result in derecognition, referring to the relevant requirements in IFRS 9, ie the draft

Interpretation would outline the Interpretations Committee's conclusions in paragraphs 12–14 of this paper.

20. The Interpretations Committee did not support proceeding with an amendment to IFRS 9. Committee members concluded that the requirements in IFRS 9 do not need to be changed. Rather, they concluded that the matter would be best addressed by including as authoritative requirements an explanation of how to apply the requirements in IFRS 9 to modifications and exchanges of financial liabilities that do not result in derecognition.

Question for the Board
Do any Board members object to the release of a draft Interpretation that would explain how to apply the requirements in IFRS 9 to modifications and exchanges of financial liabilities that do not result in derecognition of the financial liability?