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Debt restructuring

Points of reference for preparers of financial reports

Debt restructuring transactions can be intimidating to record, with most entities encountering them on a relatively infrequent basis. Depending on the facts and circumstances around each restructuring event, there may be significant variability in the financial reporting outcome. Judgement is required, especially where quantitative and qualitative indicators differ on the indicated approach. For additional assistance please email your Partner at Grant Thornton or email the Financial Reporting Advisory team at fra@au.gt.com.

Debt restructuring is common for entities for a variety of reasons – debt can change to fund acquisitions or cover a short-fall in working capital, and deferrals of payment can occur due to financial difficulty. Consistent within this is a common theme: a change to the underlying credit agreement occurred such that the conditions related to the debt were amended.

This guide seeks to provide a basic framework for entities to apply when accounting for debt restructuring by explaining the most common issues encountered.

What is debt restructuring?

Debt restructuring occurs whenever negotiations are entered into with a financier – for example, a bank, note holder or other lender – such that the borrower's obligations related to the amounts borrowed are altered. This alteration can take the form of one or more of the following:

- Replacement of one debt instrument with another;
- Extension of debt term;
- Alteration of interest rates;
- Alteration of timing of repayments, including payments of interest;
- Alteration of method of calculation of interest (e.g. "simple" to "daily compounding");
- Altering source of underlying interest rate (e.g. BBSW to the Cash Rate);
- Inclusion of equity or derivative element;
- Change of denominated currency;
- Alteration of debt to secured from unsecured (or vice versa); or
- Partial forgiveness.

This list is not exhaustive – debt transactions can be complex and each amendment to debt should be assessed to ensure modification accounting is correctly applied.

Accounting differences: modification vs extinguishment

	Modification	Extinguishment
Impact on liability	No change, except for capitalised fees	Old debt derecognised New debt recognised
Lender fees	Lender fees Capitalise (AASB 9.5.4.3)	Expense (AASB 9.B3.3.6)
3rd party fees	Capitalise (AASB 9.5.4.3)	Expense (AASB 9.B3.3.6)
Gain/Loss on event	Difference between net present values of past and future cash flows	Difference between old debt and fair value of new debt

Accounting for debt restructuring

The accounting for debt restructuring is governed by AASB 9 *Financial Instruments*. The accounting is dependent on whether the modified debt terms are considered "substantially different" to the previous debt terms – a definition defined by AASB 9.

AASB 9 explains that for a modified term to be "substantially different" from previous terms, a test that is commonly referred to as "the 10% test" should be performed. This test compares the net present value of the revised cash flows (inclusive of fees paid and net of fees received) to the present value of the remaining cash flows of the existing debt. If the difference in those cash flows is greater than 10% (when compared to the original cash flows) then the modified debt is considered to be "substantially different" – and the debt treated as "extinguished".

For the 10% test to be performed correctly, the discount rate used in calculating the net present value of the revised cash flows must be identical to the original debt – therefore the cash flows are discounted at the effective interest rate ("EIR") of the debt being replaced or modified. For example, if the effective interest rate for the existing debt was 5% and the modified effective interest rate was 7%, the present value of revised cash flows should be calculated using 5%.

In some instances, even though the 10% test is not satisfied, sufficient qualitative information may be available to require extinguishment accounting be applied..

For example, a debt which was previously borrowed in Australian Dollars but is now denominated in American Dollars, or an equity instrument being added to the modified debt is likely to qualitatively indicate that extinguishment accounting is appropriate. The qualitative test, by nature, is highly subjective and should be carefully considered by management.

When triggered, an extinguishment event results in pre-existing debt being derecognised and new debt being recognised at its fair value. Any gain or loss from the derecognition and recognition is recognised as an extinguishment gain or loss within profit or loss.

A non-substantial change – referred to as a "modification" – is accounted for by adjusting the carrying value of the existing liability, with the difference being recognised in profit and loss as a modification gain. The adjusted carrying amounts are then amortised over the remaining term of the modified debt using the original effective interest rate.

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Example: Modification

Facts:

BorrowerCo entered in an agreement to borrow $1,000,000 in Year 0. The terms of this debt are as follows:

- Interest rate: 10% per annum, fixed, paid annually in arrears;
- Maturity: 10 years; and
- Principal is repaid at end of term.

No legal, bank or broker fees were incurred in relation to this debt. Fair value was equal to the amount borrowed at the time of the agreement.

At the end of year 5, the terms of the debt were renegotiated with the following terms:

- No payments are due until the end of year 10;
- At Year 10, $1,600,000 will be repaid to the lender;

Legal fees incurred related to restructuring of the debt totalled $50,000.

Discussion: Modification vs Extinguishment

The original debt is carried at amortised cost and the contract did not involve any capitalised finance costs (for example bank, lawyer or broker fees). As a result, the present value of its future cash flows is $1,000,000.

The future cash flows of the replacement debt are considered by reference to the interest rate of the original debt – 10%. The effective interest rate of this replacement debt is irrelevant for the purposes of this test – and total $993,474 (refer table "Replacement Debt" right).

Legal fees related to the restructure of the debt are added to the present value of the revised cash flow, resulting in the present value of the revised cash flows being:

NPV of replacement debt:	$ 993,474
Legal fees:	$ 50,000
Total	$1,043,474

When compared to the net present value of future cash flows for the Original Debt:

NPV of Replacement Debt	$1,043,474
NPV of Original Debt	$1,000,000
Ratio:	104.3%

Because the percentage change in the net present value is less than 10%, modification accounting is applied.

A finance gain of $6,526 results ($1,000,000 - $993,474).

Journals required: Modification

In recording the journals for modification accounting, the objective is to maintain the effective interest rate of the previously-recognised debt as required by AASB 9.5.4.3.

For our example, this results in the following journals at the date of the new debt:

Dr.	Debt	$50,000	
Cr.	Cash		$50,000

Legal fees incurred

Dr.	Debt	$6,526	
Cr.	Debt Modification		$6,526

Finance cost gain on modification

Original Debt

Interest	10%
Principal	1,000,000
Maturity	Year 10

Year	Cash Flow	Book value
0	1,000,000	(1,000,000)
1	(100,000)	(1,000,000)
2	(100,000)	(1,000,000)
3	(100,000)	(1,000,000)
4	(100,000)	(1,000,000)
5[a]	(100,000)	(1,000,000)
6	(100,000)	(1,000,000)
7	(100,000)	(1,000,000)
8	(100,000)	(1,000,000)
9	(100,000)	(1,000,000)
10	(1,100,000)	-

Replacement Debt

Maturity	Year 10

Year	Cash Flow	Present Value
5[a]	-	-
6	-	-
7	-	-
8	-	-
9	-	-
10	(1,600,000)	(993,474)[b]

[A] Year of restructure
[B] Calculated as ($1,600,000)/(1.10^5)

Example: Extinguishment

Facts

BorrowerCo entered in an agreement to borrow $1,000,000 in Year 0. The terms of this debt are as follows:

- Interest rate: 10% per annum, fixed, paid annually in arrears;
- Maturity: 10 years; and
- Principal is repaid at end of term.

No legal, bank or broker fees were incurred in relation to this debt. Fair value was equal to the amount borrowed at the time of the agreement.

At the end of year 5, the terms of the debt were renegotiated such that repayments cease until end of Year 11, when $1,500,000 will be paid to the lender.

Legal fees incurred related to restructuring of the debt totalled $50,000

Discussion: Modification vs Extinguishment

The present value of future cash flows of the original debt is $1,000,000 and the present value of the future cash flows will be considered by reference the interest rate of the original debt – 10%, totalling to $896,711 (refer table "Replacement Debt" right).

Legal fees related to the restructure of the debt are added to the present value of the revised cash flow, resulting in the present value of the revised cash flows being:

NPV of replacement debt:	$846,711
Legal fees:	$ 50,000
Total	$896,711

When compared to the net present value of future cash flows for the Original Debt:

NPV of Replacement Debt	$896,711
NPV of Original Debt	$1,000,000
Ratio:	89.6%

Because the percentage change in the net present value is greater than 10%, extinguishment accounting is applied. This involves derecognition of the original debt and recognition of the replacement debt at fair value as required by AASB 9 when a new financial liability is recognised.

Assuming that the entity is in increased financial difficulty, we will propose 15% as the appropriate fair value discount rate for the new debt. Note that AASB 9.B3.3.6 requires that fees incurred be expensed in this instance.

A finance gain of $301,509 results:

($1,000,000 - $648,491+$50,000).

Original Debt

Interest	10%
Principal	1,000,000
Maturity	Year 10

Year	Cash Flow	Book value
0	1,000,000	(1,000,000)
1	(100,000)	(1,000,000)
2	(100,000)	(1,000,000)
3	(100,000)	(1,000,000)
4	(100,000)	(1,000,000)
5[a]	(100,000)	(1,000,000)
6	(100,000)	(1,000,000)
7	(100,000)	(1,000,000)
8	(100,000)	(1,000,000)
9	(100,000)	(1,000,000)
10	(1,100,000)	-

[a]Year of restructure

Replacement Debt

		Present value	
Year	Cash Flow	@10%	@15%
5[a]	(50,000)[b]	(50,000)	-
6	-	-	
7	-	-	
8	-	-	
9	-	-	
10	-	-	
11	(1,500,000)	(846,711)[c]	(648,491)

[A] Year of restructure

[B] Legal fees

[C] Calculated as $(1,500,000)/(1.10^6)$

Journals required: Extinguishment

In recording the journals for extinguishment accounting, the objective is to derecognise the original debt and recognise the fair value of the replacement debt using the effective interest rates of the replacement debt as required by AASB 9.3.3.2.

For our example, this results in the following journals at the date of the new debt

Dr.	Extinguishment loss	$50,000	
Cr.	Cash	$50,000	

Legal fees incurred

Dr.	Old debt	$1,000,000	
Cr.	New debt		$648,491
Cr.	Extinguishment gain		$351,509

Finance cost on modification

Contact

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Other Considerations

Changes from AASB 139 *Financial Instruments: Recognition and Measurement*

The previous accounting standard did not explicitly explain the accounting treatment for modification accounting, hence, a policy choice existed:

- Amortise the modified debt over the remaining useful life of the debt (no immediate impact on the profit or loss); or
- The difference between the original debt and the modified debt immediately recognised in profit or loss.

In AASB 9, no policy choice exists and the difference between the original debt and the modified debt **should immediately be recognised in profit or loss** as in the above "Example: Modification".

Prepayment feature

If a prepayment feature exists within a debt arrangement, at the date of restructuring the present value of the existing debt must be equal to the book value of the debt.

Debt syndication

Debt syndication is when large borrowing arrangements for a single borrower are funded by multiple lenders – that is, by a syndicate. In such cases, the borrower must determine if this is recorded as a debt from a single lender ("Lead Lender") or multiple debt arrangements with multiple lenders. The above determination changes the accounting for debt restructuring. Please feel welcome to contact Financial Reporting Advisory for guidance in such instances.

Conclusion

It is important to understand and consider all the terms and conditions of the original debt, replacement debt and the restructuring arrangement before initiating the "10% test" – the qualitative analysis step may render the 10% test irrelevant and its omission may result in incorrect accounting being applied.

For further information on any of the information included in this guide or additional guidance related to debt restructuring, please contact your Grant Thornton relationship partner or a member of Financial Reporting Advisory at fra@au.gt.com.