Technical Accounting Alert

Debt modifications

Introduction

The purpose of this alert is to provide assistance when accounting for a modification to the terms of a financial liability (e.g. bank borrowings).

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

Note: it is assumed throughout this TA alert that the liabilities in question are not derivatives and have not been designated at fair value through profit or loss.

Guidance

Entities quite often modify the terms of loans by agreement with their creditors. This is sometimes referred to as debt restructuring. Debt restructuring can take various legal forms including:

- An amendment to the terms of a debt instrument (e.g. the amounts and timing of payments of interest and principal); or
- A notional repayment of existing debt with immediate re-lending of the same or a different amount.

The borrower will usually incur costs in a debt restructuring, and other fees might also be paid or received.

The accounting treatment of a debt restructuring depends on whether the modified terms (or new debt instrument) are "substantially different" to the previous terms (or debt instrument). IAS 39 determines whether the new or modified debt is substantially different based primarily on a "10% test". This test requires a calculation of whether the present value of the **revised cash flows plus any costs/fees paid (less any fees received)** differs by 10% or more from the present value of the **remaining cash flows of the existing debt**. IAS 39.AG 62 requires this calculation to be performed using the original EIR. The EIR is a constant rate determined at inception of the original debt (unless the debt is floating rate debt - IAS 39.AG 7).

A modification to the terms of a financial liability should be accounted for as follows:

- A substantial modification should be accounted for as an extinguishment of the existing liability and the recognition of a new liability (IAS 39.40) ("**extinguishment accounting**");
- A non-substantial modification may be accounted **either** as an adjustment to the existing liability ("**modification accounting**") **or** as an extinguishment. This is mainly a matter of accounting policy choice. Qualitative factors should be considered in selecting the most appropriate policy, which should be applied consistently.

A modification is substantial if the present value of the cash flows under the new terms, including net fees paid or received, differs by 10% or more from the present value of the remaining cash flows of the existing liability. This calculation should be carried out using the original effective interest rate (EIR) (IAS 39.AG62).

Extinguishment accounting
Extinguishment accounting is covered by IAS 39.40 and involves:

- De-recognition of the existing liability;
- Recognition of the new or modified liability at its **fair value**;
- Recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one. Any incremental costs or fees incurred, and any consideration paid or received, are also included in the calculation of the gain or loss; and
- Calculating a new EIR for the modified liability, this is then used in future periods.

The fair value of the modified liability will usually need to be estimated. It cannot be assumed that fair value equals the book value of the existing liability. Fair value can be estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

One effect of extinguishment accounting can therefore be the accelerated "expensing" of transaction costs. This is because the unamortised portion of any transaction costs deducted from the original loan is included in the determination of the gain or loss on extinguishment. Any additional fees or costs incurred on modification are also included in the gain or loss.

Modification accounting
Modification accounting is covered by IAS 39.AG62 and involves:

- Adjusting the carrying value of the existing liability for fees paid or costs incurred;
- Amending the EIR at the modification date. The EIR is amended such that the adjusted carrying amount and the revised estimate of future cash flows are discounted over the revised estimated life of the liability (IAS 39.9).

No gain or loss is recorded on modification.

In modification accounting, any costs or fees adjust the carrying value of the liability (IAS 39.AG62). The main issue with modification accounting is that the original EIR will not (usually) exactly discount the revised cash flows to the adjusted carrying value. This conflicts with the general definition of the effective interest method in IAS 39.9. It is therefore necessary to amend the EIR.

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Examples

Modification accounting

On 1.1.X1 entity A issues 10 year bonds for $1,000,000, bearing interest at 10% (payable annually on 31.12 each year). The bonds are redeemable on 31.12.X10 for $1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1.1.X6 (ie after 5 years) Entity A and the bondholders agree to a modification in accordance with which:

- No further interest payments are made;
- The bonds are redeemed on the original due date (31.12.X10) for $1,600,000; and
- Legal and other fees of $50,000 are incurred.

Analysis

The first step is to determine whether the "10% test" is met. In this example, the present value of the remaining cash flows of the existing debt is $1,000,000. This amount is compared to the total of fees paid on modification ($50,000) and the present value of the future payment(s) under the modified terms. The present value in this example is $1,600,000 discounted at 10% (the original EIR) over 5 years ($993,474). The sum of this amount and fees incurred is $1,043,474, which is within 10% of $1,000,000. Modification accounting therefore applies.

On this basis:

- The fees paid of $50,000 are netted against the existing liability, resulting in an adjusted carrying amount of $950,000;
- The EIR is recalculated. This is the rate which discounts the future cash flows ($1,600,000 in five years time) to the adjusted carrying amount of $950,000. The adjusted EIR is 10.99%
- The adjusted EIR is used to determine the amortised cost and interest expense in future periods (see table below).

The accounting entries on the modification date are therefore:

1.1.X6	Debit	Credit
Liability	$50,000	
Cash (costs and fees paid)		$50,000

The table below shows pre-and post-modification amortised cost and interest expense amounts:

Year	Opening liability	Cash flows (interest and principal)	Interest expense (at EIR of 10%/10.99%)	Closing liability
1.1.X1		1,000,000		
20X1	1,000,000	(100,000)	100,000	1,000,000
20X2	1,000,000	(100,000)	100,000	1,000,000
20X3	1,000,000	(100,000)	100,000	1,000,000
20X4	1,000,000	(100,000)	100,000	1,000,000
20X5	1,000,000	(100,000)	100,000	1,000,000
Adjustment on 1.1.X6	(50,000)			
20X6	950,000	-	104,394	1,054,394
20X7	1,054,394	-	115,866	1,170,259
20X8	1,170,259	-	128,598	1,298,857
20X9	1,298,857	-	142,729	1,441,587
20X10	1,441,587	(1,600,000)	158,413	-

Extinguishment accounting

Assume the same facts as above with respect to the original bonds. On 1.1.X6 (ie after 5 years) Entity A and the bondholders agree to a modification in accordance with which:

- The term is extended to 31.12.X12;
- Interest payments are reduced to $50,000;
- The bonds are redeemable on 31.12.X12 for $1,500,000; and
- Legal and other fees of $50,000 are incurred.

Entity A determines that the market interest rate at which it could issue new bonds with similar terms is 11% (on 1.1X6).

Analysis

The present value of the remaining cash flows of the existing debt on the modification date is $1,000,000. This is compared to the total of fees paid ($50,000) and the present value of the future payment(s) under the modified terms. The present value in this example is $1,500,000 discounted at 10% (the original EIR) over 7 years ($769,737), plus the present value of the seven interest payments of $50,000 ($293,421). The total of these amounts is $1,113,158. This differs from $1,000,000 by more than 10%. Hence extinguishment accounting is required.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which Entity A could issue new bonds with similar terms). The estimated fair value on this basis is $958,097. A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred

The **loss** in this case is:

$1,000,000 - $958,097 - $50,000 = $8,097

The accounting entries recorded on 1.1.X6 are:

1.1.X6	Debit	Credit
New liability		$958,097
Existing liability	$1,000,000	
Cash (costs and fees paid)		$ 50,000
Loss on extinguishment (income statement)	$8,097	
Loss on extinguishment (income statement)	$30,000	

The modified liability is subsequently accounted for using a new EIR. The new EIR in this case is 11% (the rate used in the present value calculation to estimate the fair value of the modified loan). The table below shows the amortised cost and interest expense amounts for the original and modified loans:

Year	Opening liability	Cash flows (interest and principal)	Interest expense (at EIR of 10%/11%)	Closing liability
1.1.X1		1,000,000		
20X1	1,000,000	(100,000)	100,000	1,000,000
20X2	1,000,000	(100,000)	100,000	1,000,000
20X3	1,000,000	(100,000)	100,000	1,000,000
20X4	1,000,000	(100,000)	100,000	1,000,000
20X5	1,000,000	(100,000)	100,000	1,000,000
De-recognition of existing loan	(1,000,000)			
Recognition of modified loan	958,097			
20X6	958,097	(50,000)	105,391	1,013,488
20X7	1,013,488	(50,000)	111,484	1,074,972
20X8	1,074,972	(50,000)	118,247	1,143,219
20X9	1,143,219	(50,000)	125,754	1,218,973
20X10	1,218,973	(50,000)	134,087	1,303,060
20X11	1,303,060	(50,000)	143,336	1,396,396
20X12	1,396,396	(1,550,000)	153,604	-

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au