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Navigating balance sheet funding

Managing IFRS debt restructuring challenges in a rising interest rate environment

By Faisal Shaikh and Maria Ruggiero

Debt restructuring is not a new concept, but it tends to increase in popularity at times of financial stress and economic volatility. The current high inflationary and high interest rate macro-economic environment is no exception.

Recent waves of debt restructuring occurred after the 2008-2009 financial crisis and, more recently, during the COVID-19 pandemic which led to many companies contending with the complex accounting rules in this area under International Financial Reporting Standards (IFRS). Even in the simpler cases of debt restructuring, the accounting can be difficult to navigate. A lesson learned from both the last financial crisis and the COVID-19 pandemic was to involve IFRS accounting specialists before any restructuring is concluded to minimise the risk of unintended accounting outcomes, including volatility to profit or loss.

This publication shares some of the nuances and pitfalls to watch out for. However, there is no substitute for engagement with knowledgeable and experienced specialists. If you would like to discuss further, get in touch with the contacts at the end of this publication.

Corporate financial and economic challenges

For several months, businesses have faced rising costs of production and supply alongside increases in their cost of financing. Where costs incurred could not be passed to the consumer, business margins have been squeezed.

In an effort to contend with the increased financial burden and liquidity pressures, some borrowers have approached their lenders to ask for concessions on borrowing arrangements, for example relaxation of covenants, modifications or extensions of payment terms or even forgiveness of debt in exchange for equity in the borrower. Others have sought to renegotiate their debt to get certainty of interest payments for a longer term rather than wait until loans mature given the rising interest rate environment.

What are the consequences of amending the terms of financial instruments such as bank loans for companies that report under IFRS?

When the contractual terms of financial liabilities such as bank loans are renegotiated part way through their term, either by amending the contract or replacing the contract ('modifications'), borrowers reporting under IFRS need to consider the amendments carefully against the requirements of IFRS 9 Financial Instruments (IFRS 9).

The appropriate accounting treatment for a modification will differ depending on whether such modifications are considered 'substantial' or 'non-substantial' but will generally give rise to gains or losses in the financial statements. To determine the appropriate accounting treatment requires a thorough understanding of the facts and circumstances and any accounting policies adopted (where more than one approach is acceptable). We consider the accounting complexities for both borrowers and lenders below.

Is a renegotiation between an existing borrower and lender a modification or settlement of existing debt under its contractual terms?

Not all renegotiated debt between an existing borrower and lender is necessarily assessed as a 'modification'. Consideration should be given as to whether the transaction could be viewed as settlement of the original debt under its contractual terms and a concurrent issue of new debt on market terms. This could arise, for example, when the original debt is prepayable at par with no penalties and the borrower has a genuine practical ability to refinance the debt in the market. IFRS 9 does not provide clear guidance on the accounting in these situations and an accounting policy choice may be appropriate whereby the transaction is either treated as a modification to be assessed if it is substantial, or settlement of the original debt under its contractual terms and issuance of new on-market debt.

If the original debt is treated as settled under its existing contractual terms, the original debt would be fully derecognised from the balance sheet, including any unamortised transaction costs. The new instrument would be initially recognised at fair value. If the new debt is subsequently measured at amortised cost, any transaction costs related to the issuance of the new financial liability would be capitalised and amortised to profit or loss as part of the effective interest rate method. If the liability is subsequently measured at fair value through profit or loss, the transaction costs would be immediately recognised in profit or loss.

Alternatively, if the renegotiation is not considered to be settlement of the original debt under its contractual terms, the borrower would need to consider whether the modification to the original debt is substantial or not.

What is a 'substantial modification'?

In limited circumstances, a simple qualitative assessment will be sufficient to establish that the terms of the modified debt are substantially different from those of the original, for example when the denomination of the debt is changed to a different currency.

However, most of the time, an entity will need to do a quantitative assessment, known as the 'ten percent test'. In other words, if the net present value of the cash flows under the modified terms, including lender fees, is at least ten percent different from the net present value of the remaining cash flows of the original liability, both discounted at the original effective interest rate (EIR), then the modification is considered to be substantial.

Watch out for the discount rate

The ten percent test requires the original 'effective interest rate' (EIR) as calculated by IFRS 9. It is not the current market yield, nor is it the current cash coupon – the EIR incorporates transaction costs and any premiums or discounts that existed on day one recognition. This is particularly important for marginal cases where the present value difference is close to 10 per cent.

What are the impacts on profit or loss?

If the modification is regarded as 'substantial', the borrower would account for the modification as an extinguishment of the original debt and the recognition of new debt at fair value. Any difference between the carrying amount of the extinguished debt and the fair value of the new debt is recorded in profit or loss. Any costs or fees incurred are generally included as part of the gain or loss on extinguishment. This can be similar to a sudden fair valuing of debt which may be an unwelcome surprise. Additionally, the new debt is subject to the full initial recognition rules, including assessment of embedded derivatives that could lead to markedly different accounting.

The interest expense will effectively be reset to market as prescribed by the contract which could impact key performance indicators (KPIs) and covenants.

If the modification is regarded as 'non-substantial', the borrower is required to account for the difference between the revised cash flows as a result of the

modification, discounted at the original EIR, and the carrying amount of the existing liability, in profit or loss as a modification gain or loss. Any directly attributable costs or fees incurred adjust the carrying amount of the original liability and are amortised over the remaining life of the modified liability by adjusting the EIR.

Substantial

- Derecognition of existing liability at its carrying amount
- Recognition of a new liability at fair value
- Difference is recognised in profit or loss as a gain or loss on extinguishment
- Certain costs or fees recognised in profit or loss

vs.

Non substantial

- Carrying amount of the existing debt is adjusted to an amount equal to the revised cash flows discounted at the original EIR
- Adjustment is recognised in profit or loss as a modification gain or loss
- Carrying amount is adjusted for certain fees or costs incurred and the EIR is updated

What is the impact on hedge relationships?

If the terms of any debt instruments are modified, and those debt instruments are designated in hedge relationships for accounting purposes, then borrowers will need to consider the impact of the modification on the hedge. The consequences will depend on the specific hedge documentation, nature of the modifications, and also the type of hedge relationship. This may result in hedge ineffectiveness, discontinuation of the hedge and/or immediate reclassification of amounts deferred in the cash flow hedge reserve.

What is different when debt is exchanged for equity?

In some circumstances, borrowers might use their own equity instruments to settle all or part of their debt instruments (e.g., debt-for-equity swaps), particularly when the borrower is in financial difficulty. In such scenarios transacted at arms' length, the equity instruments are 'consideration paid'.

Generally, the difference between the carrying amount of the debt and the fair value of the equity instruments is recognised in profit or loss. If the fair value of the equity is not reliably measurable, then the equity instruments are generally measured with reference to the fair value of the debt extinguished.

In scenarios where only a part of the debt is extinguished by the issue of equity, the borrower will need to consider whether and how the consideration paid is allocated between the part of the debt extinguished and the part that remains outstanding, considering all facts and circumstances relating to the transaction. IFRS provides guidance for this scenario in *IFRIC 19 Extinguishing Financial Liabilities with Equity* which indicates a two-step process to be followed:

- Derecognise the extinguished portion of the debt: For the part of the debt that is extinguished, the difference between the carrying amount of the extinguished portion of the debt, and the consideration paid shall be recognised in profit or loss.
- Assess the remaining debt for derecognition: The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified.

The above provisions assume that the debt for equity swap is not part of an internal group restructure since these are outside the scope of IFRIC 19 and different policies apply.

So, what do borrowers think about?

- Have there been any changes to the terms of their borrowings that would be considered as settlement of the original debt under its contractual terms and issuance of new on-market debt, or 'modifications'. If a modification, are those changes substantial or non-substantial?
- Have there been any changes to the terms of their borrowings that would be considered as settlement of the original debt under its contractual terms and issuance of new on-market debt, or 'modifications'. If a modification, are those changes substantial or non-substantial?
- Do the modifications have an impact on any existing hedge relationships?
- If the entity has issued equity instruments to settle all or part of a financial liability, is the fair value of those equity instruments reliably measurable?
- If equity has been issued to partly settle debt instruments, have the terms of the remaining debt been modified, and does part of the consideration relate to that modification?
- Correctly identifying the discount rate– using the original EIR when performing the ten percent test is critically important when analysing marginal cases.
- What are the entity's accounting policies when more than one treatment is acceptable under IFRS 9?

What does the lender think about?

IFRS 9 does not include similar guidance in determining whether a modification to a financial asset is 'substantial' and should result in de-recognition from the lender's perspective.

In September 2012, the IFRS Interpretations Committee noted that in the absence of more specific guidance on modifications of financial assets, an analogy can be made to the notion of substantial modifications of financial liabilities discussed above. In doing so, a financial asset may be derecognised if a modification gives rise to substantially different terms, which should be accounted for as an extinguishment of the original financial asset and the recognition of a new financial asset.

An additional consideration for financial assets is whether the post-modified terms continue to qualify, or not qualify, as 'solely payments of principal and interest' (SPPI). A change in SPPI status could be considered a substantial modification leading to de-recognition.

If a modification of a financial asset does not result in derecognition, the gross carrying amount of the asset is recalculated as the present value of the revised contractual cash flows discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). Any difference is recognised as a modification gain or loss. Certain 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 by updating the EIR.

Credit risk assessment of modified assets Lenders should consider whether a modification is indicative of impairment or significant increase in credit risk of the borrower, or in the case of a derecognition event, whether there may be evidence that the new modified financial asset is credit-impaired upon initial recognition.

Deloitte is placed to assist as a trusted resource

The key to success in understanding the potential profit or loss impacts and risks of a debt restructuring is a robust IFRS analysis of the proposals before execution. Deloitte Treasury Assurance is a team of financial instruments specialists who have vast experience providing support to both financial institutions and corporate clients across a range of industries. We are best placed to help analyse proposals so that businesses understand the accounting outcomes and can make amendments to proposals as necessary. We can also help businesses get 'audit ready' by assisting them with documenting the IFRS implications for sharing with their auditors.

Connect with us

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