Educational material 12

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

IFRS 9 *Financial Instruments* – modifications of financial liabilities

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Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending after 31 December 2019 with a focus on IFRS 9 *Financial Instruments* (IFRS 9) and specifically the requirements related to modifications of financial liabilities.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements. This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Modifications of financial liabilities due to COVID-19

The COVID-19 pandemic has caused significant economic disruption and has resulted in many borrowers experiencing liquidity and solvency challenges. In response, borrowers may seek to renegotiate the terms of their borrowing facilities. For example, many borrowers may request concessions from lenders such as payment holidays, reduction in interest rates and other modifications to loan terms to assist with the financial burden during this time.

Where debt terms have been renegotiated, a question arises as to whether the modification of the terms is substantial or non-substantial. Paragraph 3.3.2 of IFRS 9 states that a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

To determine whether a modification of terms is substantial, a borrower performs a quantitative assessment – i.e. a '10 percent test' in accordance with paragraph B3.3.6 of IFRS 9. This paragraph outlines that terms are substantially modified if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability.

If the difference in the present values of the cash flows is less than 10 percent, entities may need to consider other qualitative factors not considered under the quantitative assessment to identify any substantial differences. This could involve a high degree of judgment.

Accounting for substantial modifications

When the contractual terms of a financial liability are substantially modified, it is accounted for as an extinguishment of the original debt instrument and the recognition of a new financial liability (IFRS 9.3.3.2). The difference between the carrying amount of the financial liability extinguished and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss (IFRS 9.3.3.3). Any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability (IFRS 9.B3.3.6). The new debt instrument is initially recognised at fair value in accordance with paragraph 5.1.1 of IFRS 9.

Accounting for non-substantial modifications

If a modification to the terms of a financial liability is not substantial, then the amortised cost of the liability is recalculated as the present value of the estimated future contractual cash flows, discounted at the original effective interest rate. The resulting gains or losses are recognised in profit or loss. Any costs or fees incurred adjust the carrying amount of the modified financial liability and are amortised over its term. (IFRS 9.B3.3.6)

3. Disclosures

Entities should also consider whether any of the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* could apply that is related to the impact of COVID-19 on financial liabilities and modifications. For example, an entity may be severely affected by the impacts of COVID-19 and restructure its debt facilities after defaulting. In this instance, an entity may consider the following the requirements in paragraph 18 of IFRS 7:

— details of any defaults during the period of principal, interest or redemption terms of those loans payable;
— the carrying amount of the loans payable in default at the end of the reporting period; and
— whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue. In addition, entities should also consider the requirement of IAS 10 *Events after the Reporting Period.* For ease of reference please refer to education paper 1 –*Events after the Reporting Period.*