Balance sheet funding considerations during times of financial distress

Combatting IFRS debt restructuring challenges during the pandemic

By Maria Ruggiero and John Kent

Debt restructuring is not a new concept, but it tends to increase in popularity at times of financial distress and the COVID-19 pandemic is no exception.

The last wave of debt restructuring arose after the 2008-2009 financial crisis, which led to many companies needing to apply 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 and progressively more challenging when the restructuring becomes more complex and ambitious. A lesson learned from the last financial crisis was to involve IFRS assurance specialists before any restructuring is concluded to minimize the risk of unintended accounting outcomes, including shocks to profit or loss.

The current pandemic environment has led to an upturn in restructurings, resurrecting those unintended accounting outcomes. 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. Deloitte welcomes the opportunity to discuss this topic with you – whether you are a borrower or a lender.

The COVID-19 corporate financial challenge

The COVID-19 pandemic is affecting economic and financial markets globally, and virtually all industries are facing challenges associated with the economic conditions resulting from efforts to address it.

For many entities, COVID-19 has caused financial burden and liquidity pressures. As a consequence, many borrowers have approached their lenders to ask for concessions on borrowing arrangements, for example reduced interest rates, relaxation of covenants, modification of payment terms including ‘payment holidays’ or even forgiveness of debt in exchange for equity in the borrower.

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

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

The appropriate accounting treatment 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. Deloitte considers the accounting complexities for borrowers below.

What is ‘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 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
Experience from 2008-2009 showed that the most common error when undertaking the ten percent test concerned 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 whereby revised terms are intended to be the minimum to achieve non-substantial modification under the ten percent test. A late correction to the discount rate could trigger very different accounting.

What are the impacts on profit or loss?

If the modification is 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 is similar to a sudden mark-to-market 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.

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

If the modification is 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 costs or fees incurred adjust the carrying amount of the original liability and are amortized over the remaining life of the new/modified liability by adjusting the EIR.

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 ineffectiveness, for example due to COVID-19 related payment holidays, or lead to discontinuation of the hedge.

What is different when debt is exchanged for equity?

What about IBOR reform?
The contractual terms of many borrowing arrangements may be required to change as a result transition from benchmark interest rates, such as interbank offer rates (IBORs) to alternative benchmark interest rates.

The IASB has issued amendments to IFRS to introduce a practical expedient, whereby the change in the basis of determining the revised cash flows will be accounted for prospectively by revising the EIR if the amendments are a direct consequence of interest benchmark reform and the new basis for determining the contractual cash flows is economically equivalent to the previous basis. As such, there will be no immediate gain or loss in profit or loss as a result of the modification to the debt because of interest rate benchmark reform. If, however, other amendments are made in addition to changing the interest reference rate, then the full de-recognition assessment needs to be undertaken.

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) because of the liquidity impact from the COVID-19 outbreak. In such scenarios, the equity instruments are 'consideration paid.'

The difference between the carrying amount of the debt and the fair value of the equity instruments is recognized 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 needs to be 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 through *IFRIC 19 Extinguishing Financial Liabilities with Equity* which indicates a two-step process to be followed:

1. Derecognize 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 recognized in profit or loss.
2. 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 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 fall to be considered as 'modifications' and, if so, 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–a very common error is failing to use the original EIR when performing the ten percent test which is critically important when analysing marginal cases.

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 derecognized 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 as 'solely payments of principal and interest' (SPPI) or vice versa. 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 recognized as a modification gain or loss. Costs or fees incurred adjust the carrying amount of the modified financial asset and are amortized over the remaining term of the modified financial asset by updating the EIR.

Deloitte is placed to assist as a trusted resource

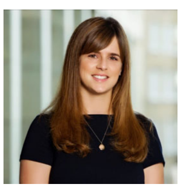
The key to success in understanding the potential profit or loss impacts and risks of a debt restructuring is a robust IFRS analysis of the proposals before execution. Deloitte is the leading IFRS assurance provider and is ideally placed to help analyze proposals so that businesses understand the IFRS 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 business' auditors.

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.

At Deloitte, we work with both issuers and investors, including providing assurance advisory services in relation to the measurement basis of the instruments, assistance with fit for purpose management documentation, calculation of booking entries, and advising on the maximization of hedging efficiency. Deloitte provides the complete suite of services and we look forward to working with businesses in the future.

Connect with us

If you would like to discuss further, please contact:



Maria Ruggiero
Corporate Treasury Accounting
Deloitte UK
mruggiero@deloitte.co.uk
Maria (Manning) Ruggiero | LinkedIn

John Kent
Deloitte Global Accounting and Reporting Advisory Leader
Deloitte UK
jrkent@deloitte.co.uk
John Kent | LinkedIn