IFRS 9 for corporates

Accounting for changes to cash flows of debt instruments

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pwc

Accounting for changes to cash flows of debt instruments

Introduction

01

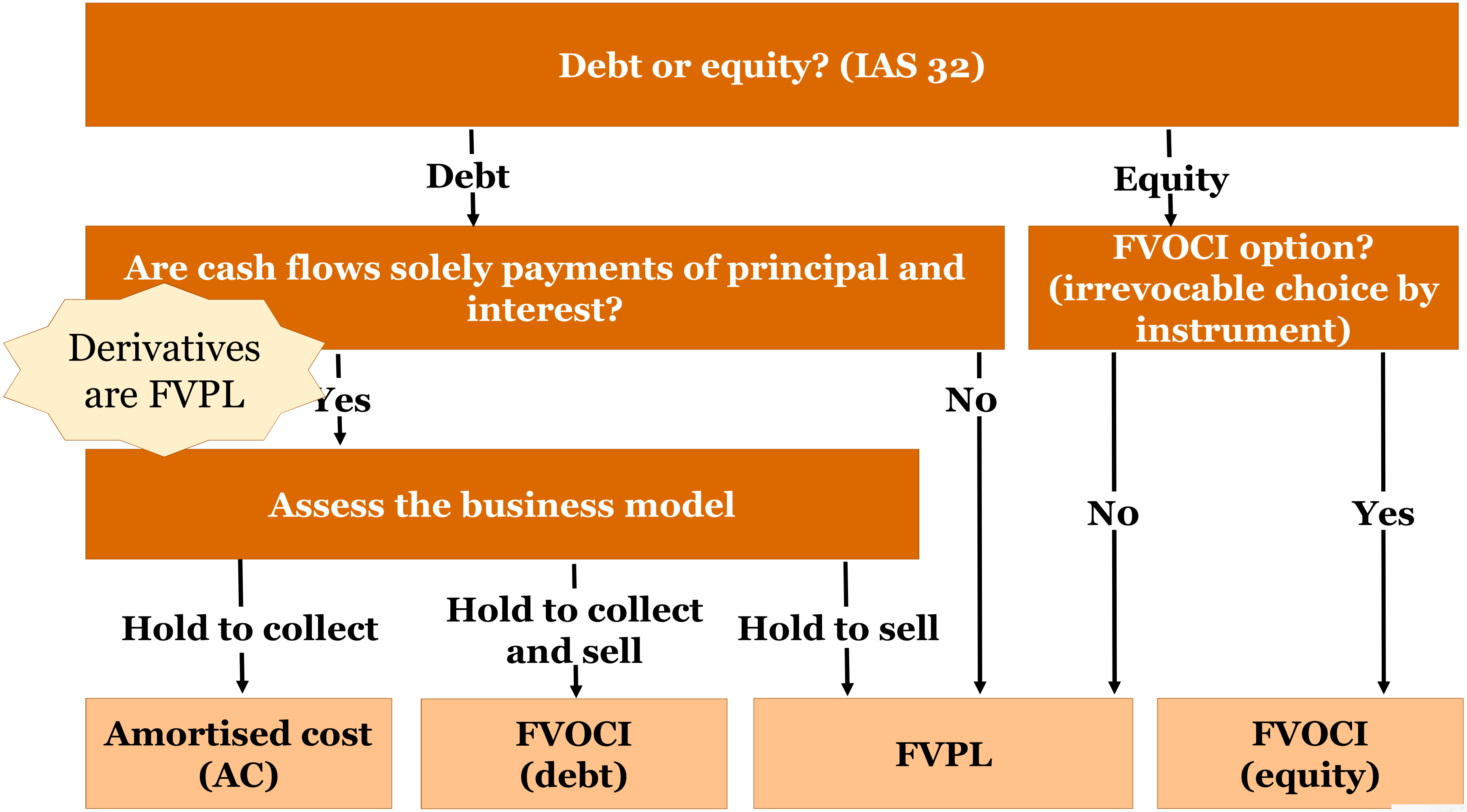
Changes to the accounting for modifications

02

Additional PwC guidance published

Recap

IFRS 9 – Classification and Measurement Financial Assets Recap



Debt or equity? (IAS 32)

Debt

Are cash flows solely payments of principal and interest?

Derivatives are FVPL

Yes

Assess the business model

Hold to collect

Amortised cost (AC)

Hold to collect and sell

FVOCI (debt)

Hold to sell

No

FVPL

Equity

FVOCI option? (irrevocable choice by instrument)

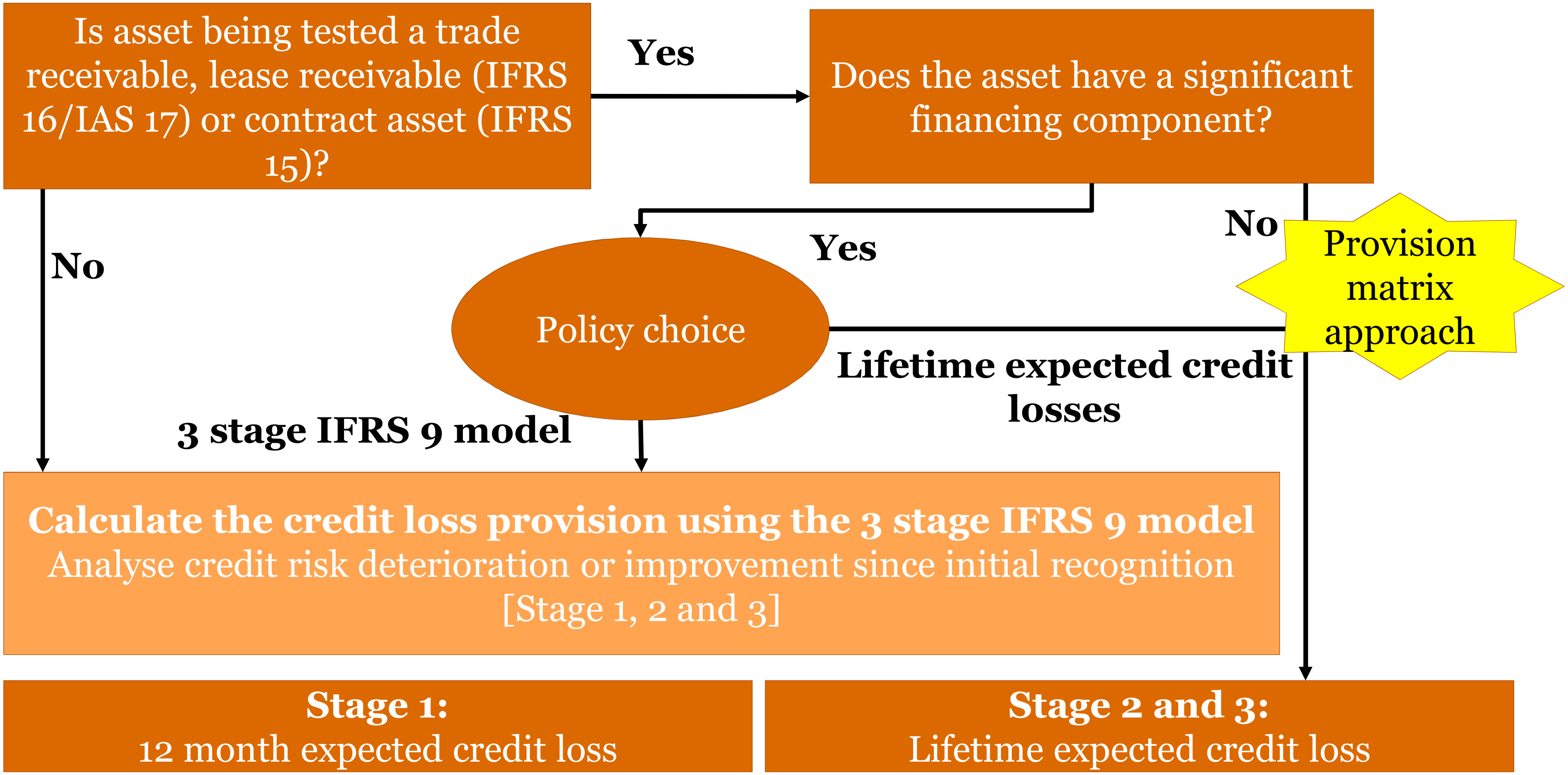
No

Yes

FVOCI (equity)

IFRS 9 Impairment Recap – AC and FVOCI

Consider forward looking information



Is asset being tested a trade receivable, lease receivable (IFRS 16/IAS 17) or contract asset (IFRS 15)?

Yes

Does the asset have a significant financing component?

No

Yes

Policy choice

No

Provision matrix approach

Lifetime expected credit losses

3 stage IFRS 9 model

Calculate the credit loss provision using the 3 stage IFRS 9 model
Analyse credit risk deterioration or improvement since initial recognition
[Stage 1, 2 and 3]

Stage 1:
12 month expected credit loss

Stage 2 and 3:
Lifetime expected credit loss

Even though these may be discounted under IFRS 15 or IAS 17 (IFRS 16) an additional provision would still be required in IFRS 9

Impairment on initial recognition of asset

Changes to cash flows of debt instruments

Accounting for changes to cash flows of debt instruments

Case study

	31/12/17 USD	31/12/16 USD
Liabilities		
Non-current liabilities		
Long-term borrowings	25,500	35,000
Provisions	2[illegible]00	2,350
Total non-current liabilities	27[illegible]00	37,350

	31/12/17 USD
Liability 1 (LIBOR +3%)	10,000
Liability 2 (5% fixed, prepayable)	10,000
Liability 3 (5.5% fixed rate, with covenants)	5,500
Total long term borrowings	**25,500**

All three liabilities have a maturity date of 31 December 2019 at which time the principal is payable.

Accounting for changes to cash flows of debt instruments

Case study – the changes

At the beginning of 2018 the following things happen:

LIBOR changes from 2% in 2017 to 3% at the beginning of 2018

The entity expects to prepay Liability 2 at the beginning of 2019, but there will be a penalty of USD 100

The entity re-negotiates Liability 3 to relax the interest cover covenant, in exchange for an increased interest rate of 6%

Accounting for changes to cash flows of debt instruments

Overview

Floating rate
Para B5.4.5

Results in no gain or loss

=

Other changes
Para B5.4.6

Results in gain or loss

+ −

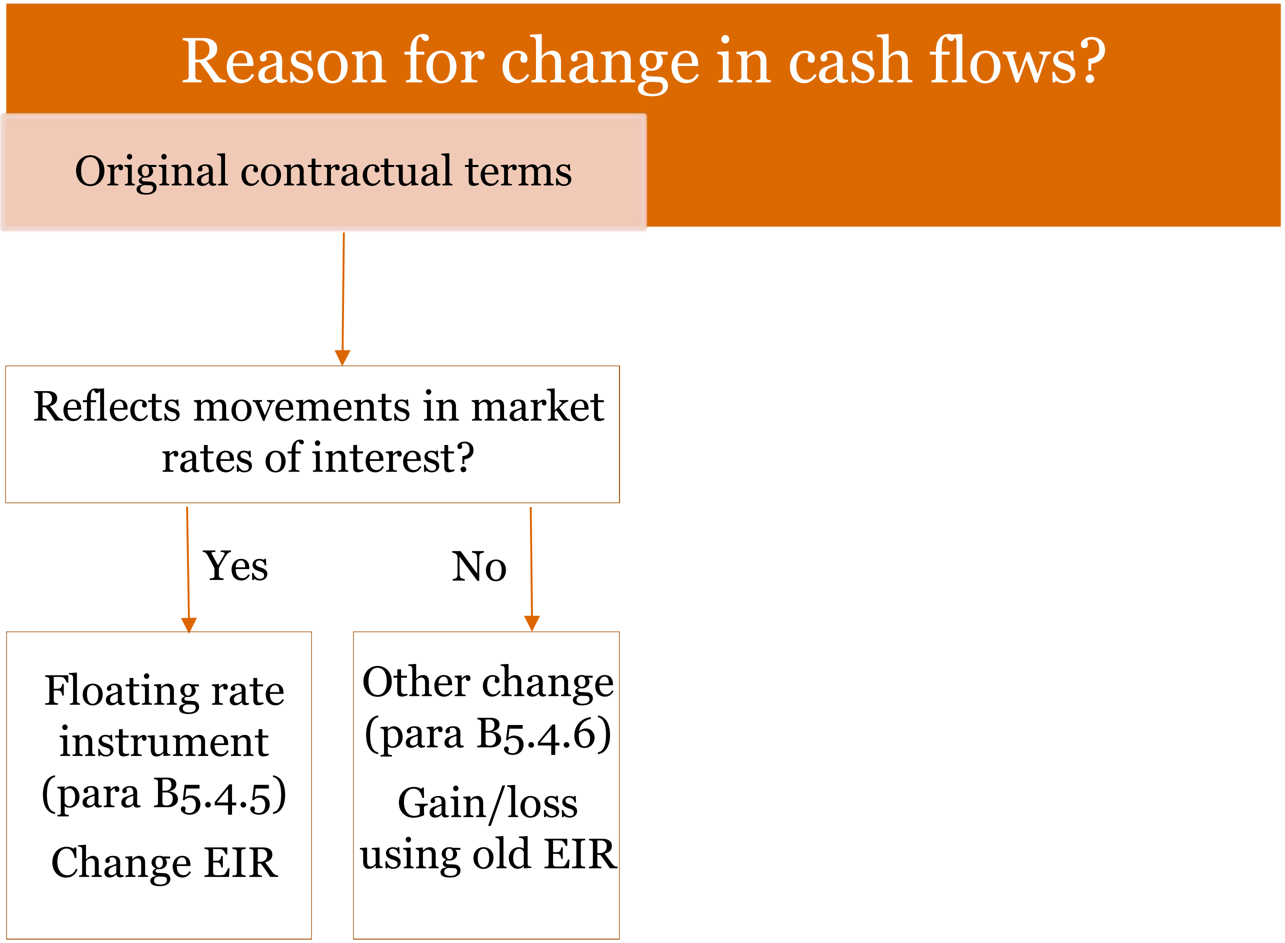
Modifications
Para 5.4.3

Results in gain or loss

+ −

Accounting for changes to cash flows of debt instruments

Which guidance should you apply?



Reason for change in cash flows?

Original contractual terms

Reflects movements in market rates of interest?

Yes

No

Floating rate instrument (para B5.4.5)

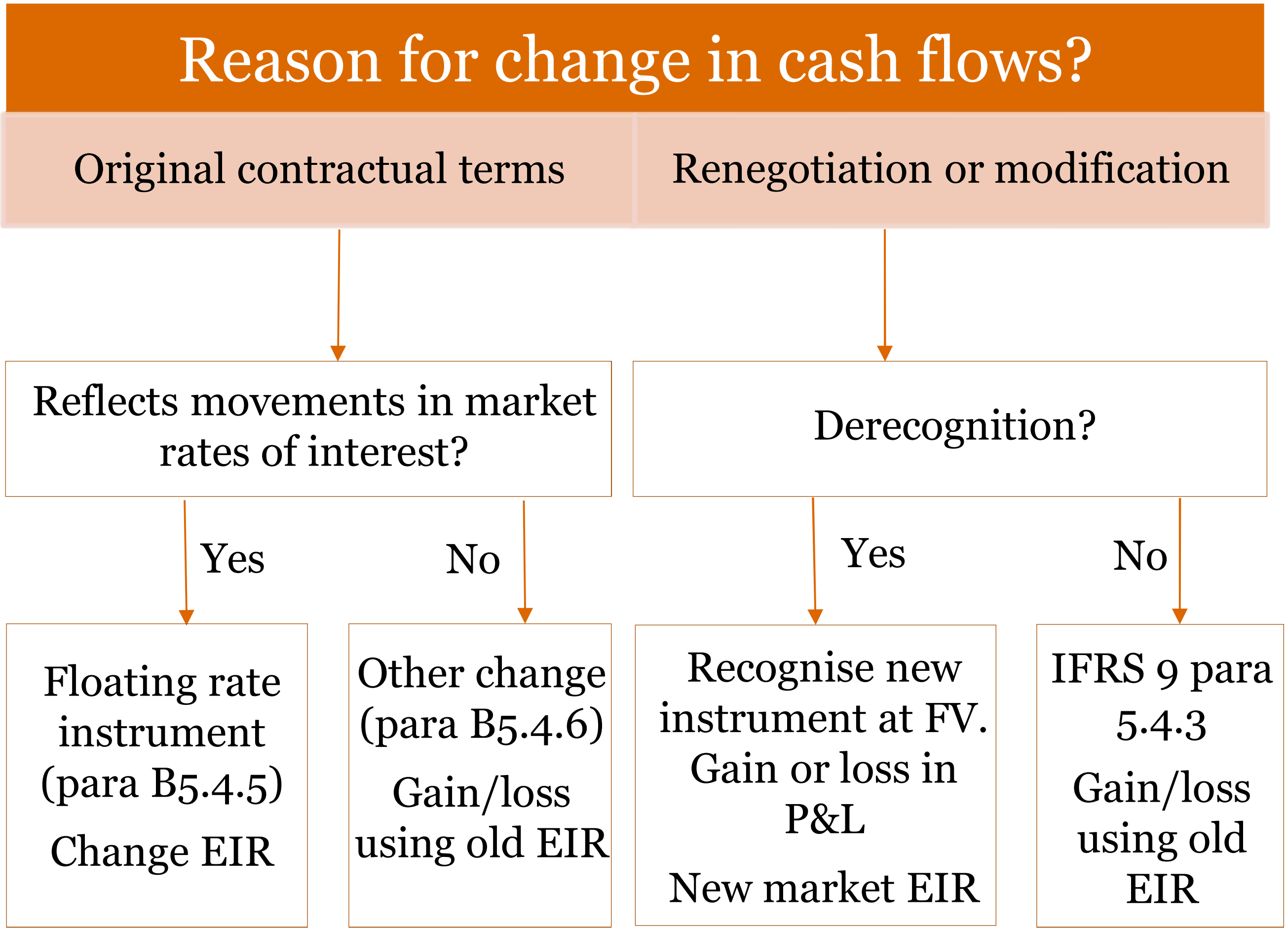
Change EIR

Other change (para B5.4.6)

Gain/loss using old EIR

Accounting for changes to cash flows of debt instruments

Which guidance should you apply?



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Yes

No

Floating rate instrument (para B5.4.5)

Change EIR

Other change (para B5.4.6)

Gain/loss using old EIR

Recognise new instrument at FV. Gain or loss in P&L

New market EIR

IFRS 9 para 5.4.3

Gain/loss using old EIR

Question 1

Entity A has a term loan which pays interest at LIBOR plus 2%. The entity is close to breaching a covenant and renegotiates the loan to remove or relax the covenant in return for increasing the credit margin applied to the loan to 3%. The new credit spread reflects the amended terms of the loan and entity A's current credit risk (assume no derecognition).

Which guidance in IFRS 9 applies to the change in cash flows of the loan?

A –Floating rate loan – reset EIR (B5.4.5)

B –Other change – loss using old EIR (B5.4.6)

C – Modification – loss using old EIR (5.4.3)

What is the effect of the changes?

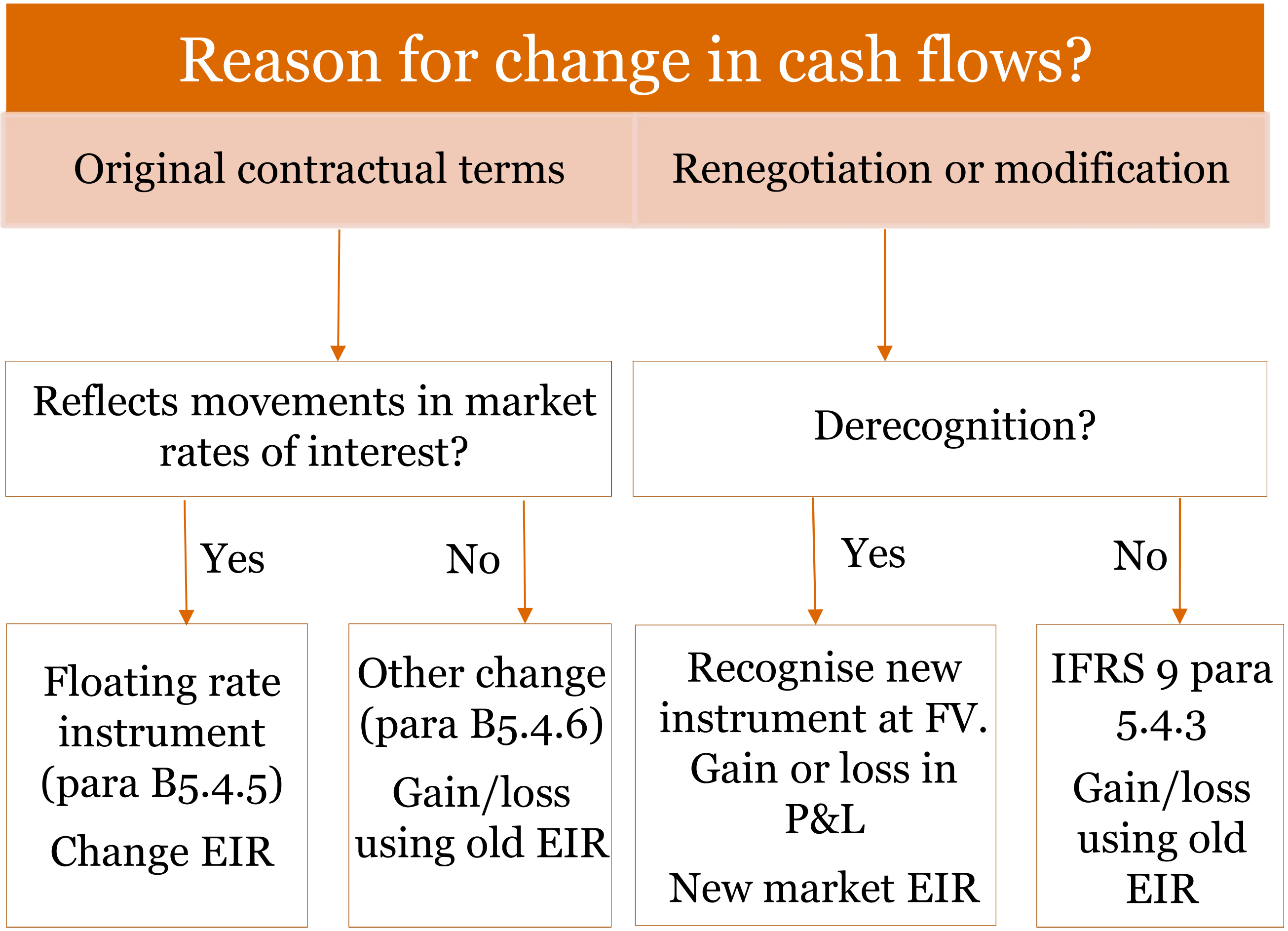
Liability 1

Reminder:

- Loan of USD 10,000
- Interest is paid at LIBOR + 3%
- LIBOR changes from 2% to 3%

Accounting for changes to cash flows of debt instruments

Liability 1



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Yes

No

Floating rate instrument (para B5.4.5)

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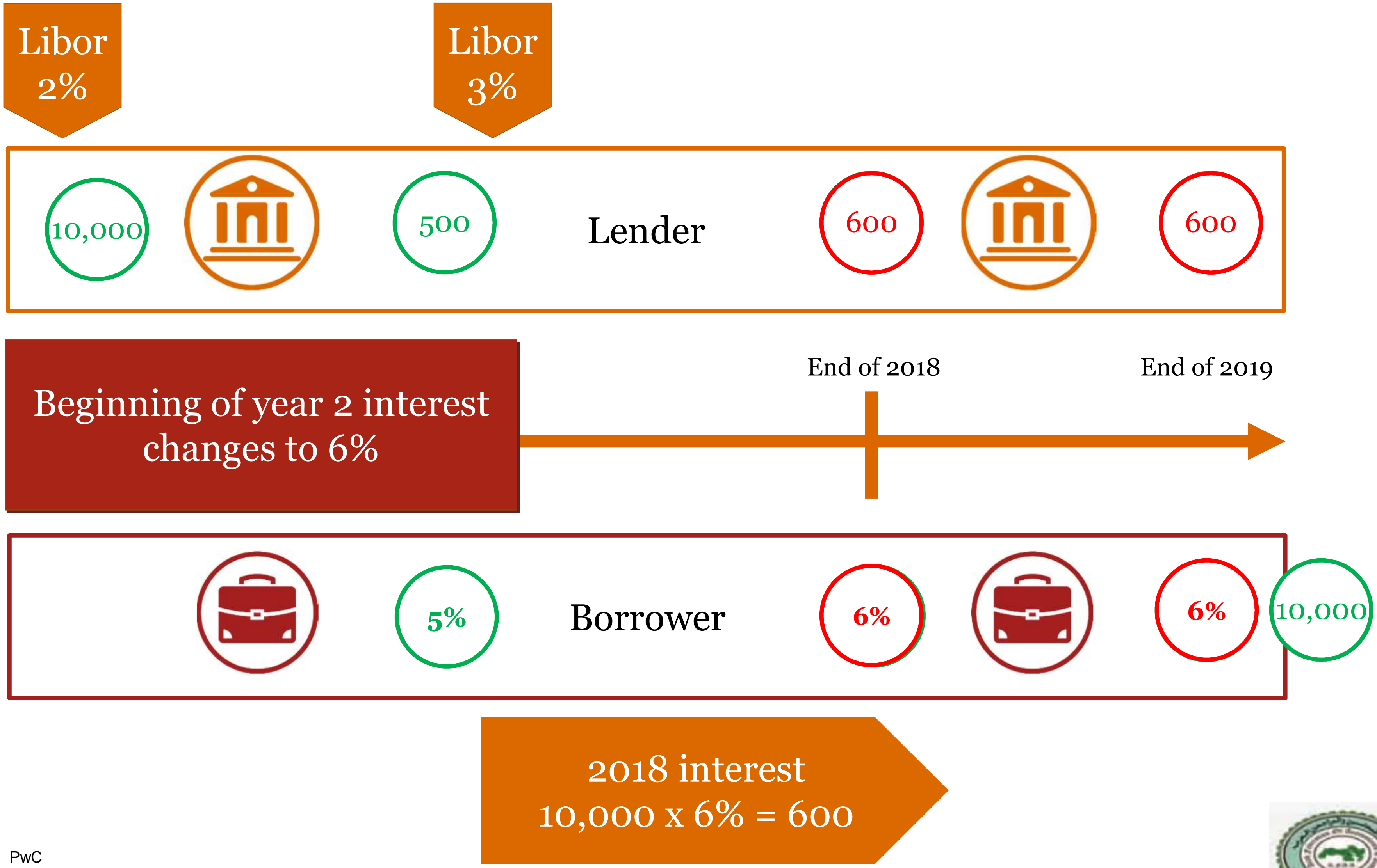
What is the effect of the changes?

Liability 1 - Update the EIR (B5.4.5 applied)



Libor 2%

Libor 3%

10,000

500

Lender

600

600

Beginning of year 2 interest changes to 6%

End of 2018

End of 2019

5%

Borrower

6%

6%

10,000

2018 interest
10,000 x 6% = 600

What is the effect of the changes?

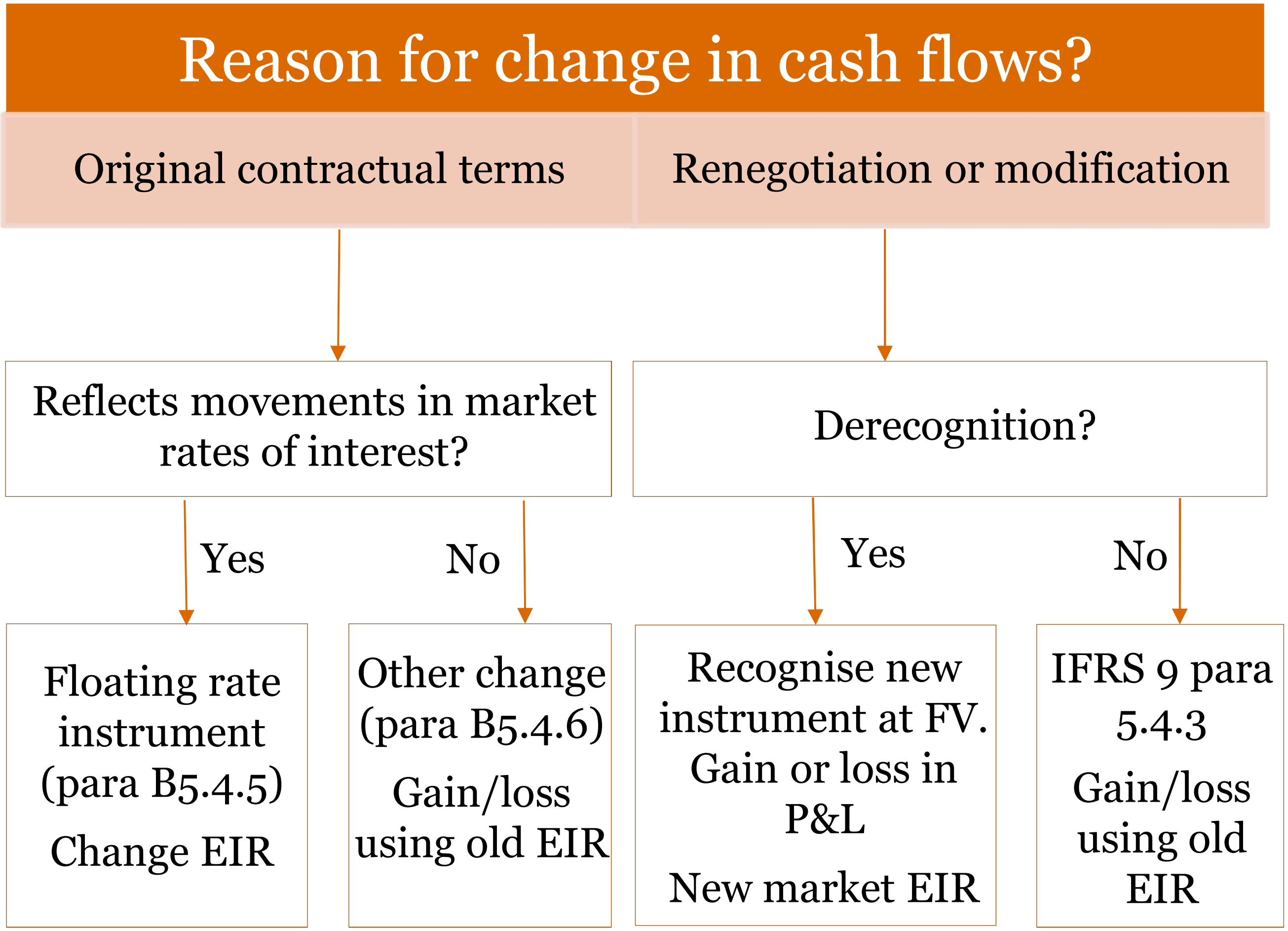
Liability 2

Reminder:

- Loan of USD 10,000
- Interest is paid at a fixed rate of 5%
- The loan is prepayable at par with a penalty of USD 100
- The entity expects to prepay the liability at the beginning of 2019

Accounting for changes to cash flows of debt instruments

Liability 2



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Yes

No

Floating rate instrument (para B5.4.5)

Change EIR

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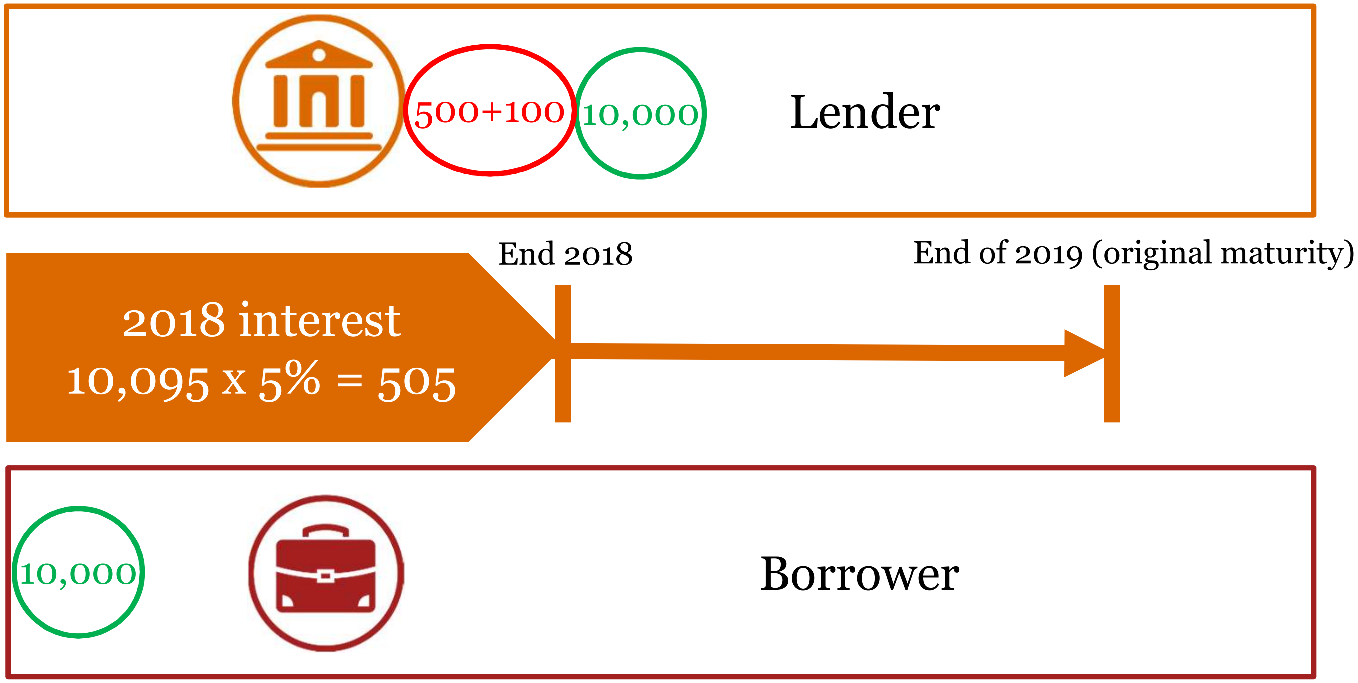
What is the effect of the changes?

Liability 2 - Early repayment **-** *No update to EIR (B5.4.6)*

Beginning of 2018 the entity decides to prepay at the beginning of 2019



2018 interest
10,095 x 5% = 505

The difference of 95 is recognised immediately in P&L

What is the effect of the changes?

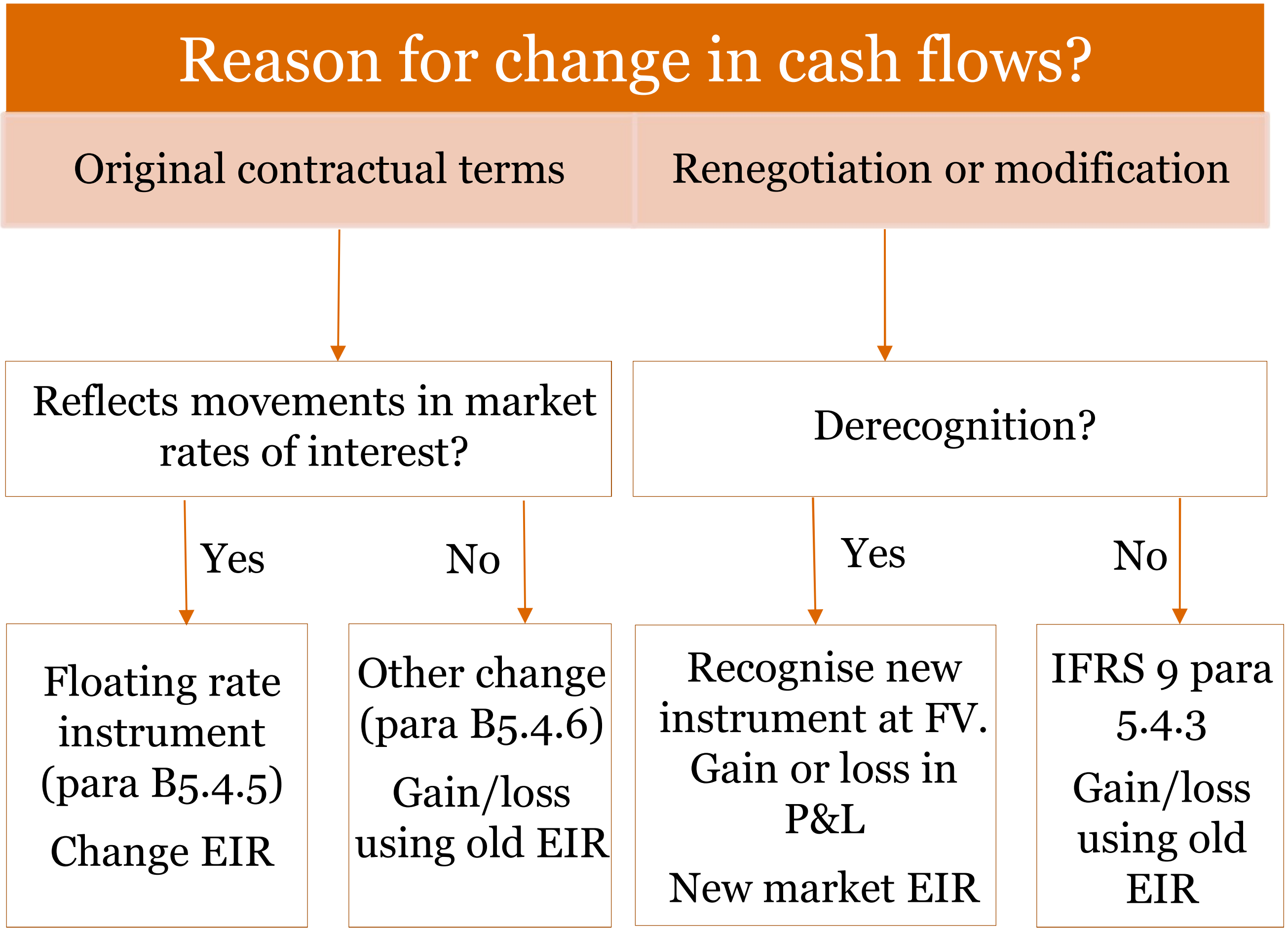
Liability 3

Reminder:

- Loan of USD 5,500
- Interest cover covenant relaxed in exchange for an increase in interest rate from 5.5% to 6%
- The loan contract did not allow for a reset of interest rates

Accounting for changes to cash flows of debt instruments

Liability 3



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Floating rate instrument (para B5.4.5)

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Other change (para B5.4.6)

Gain/loss using old EIR

Yes

No

Recognise new instrument at FV. Gain or loss in P&L

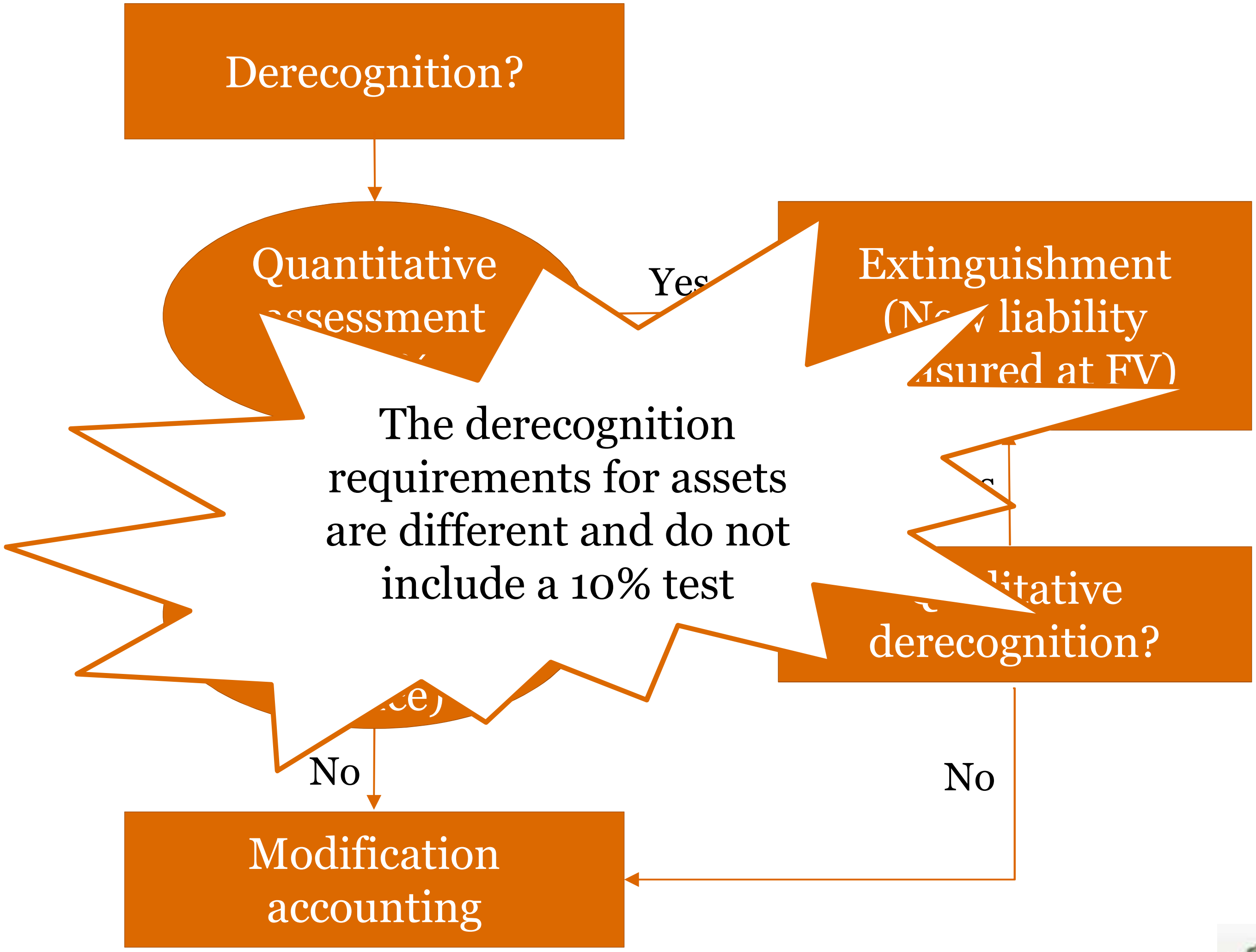
New market EIR

IFRS 9 para 5.4.3

Gain/loss using old EIR

What is the effect of the changes?

Liability 3 – Derecognition or modification accounting



Derecognition?

Quantitative

ssessment

Yes

Extinguishment

liability

sured at FV)

The derecognition requirements for assets are different and do not include a 10% test

litative

derecognition?

ce)

No

No

Modification accounting

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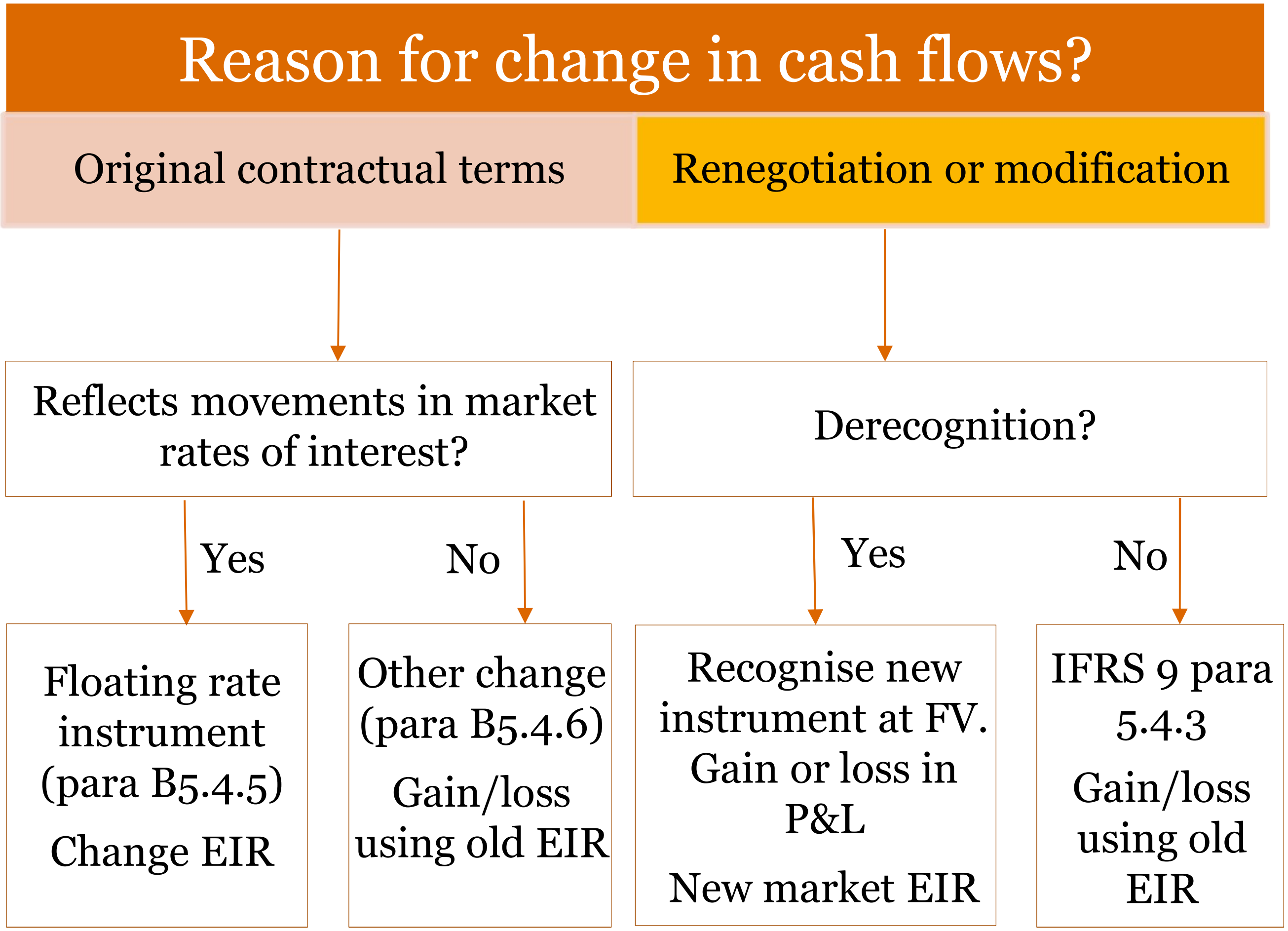
Liability 3



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Yes

No

Floating rate instrument (para B5.4.5)

Change EIR

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New market EIR

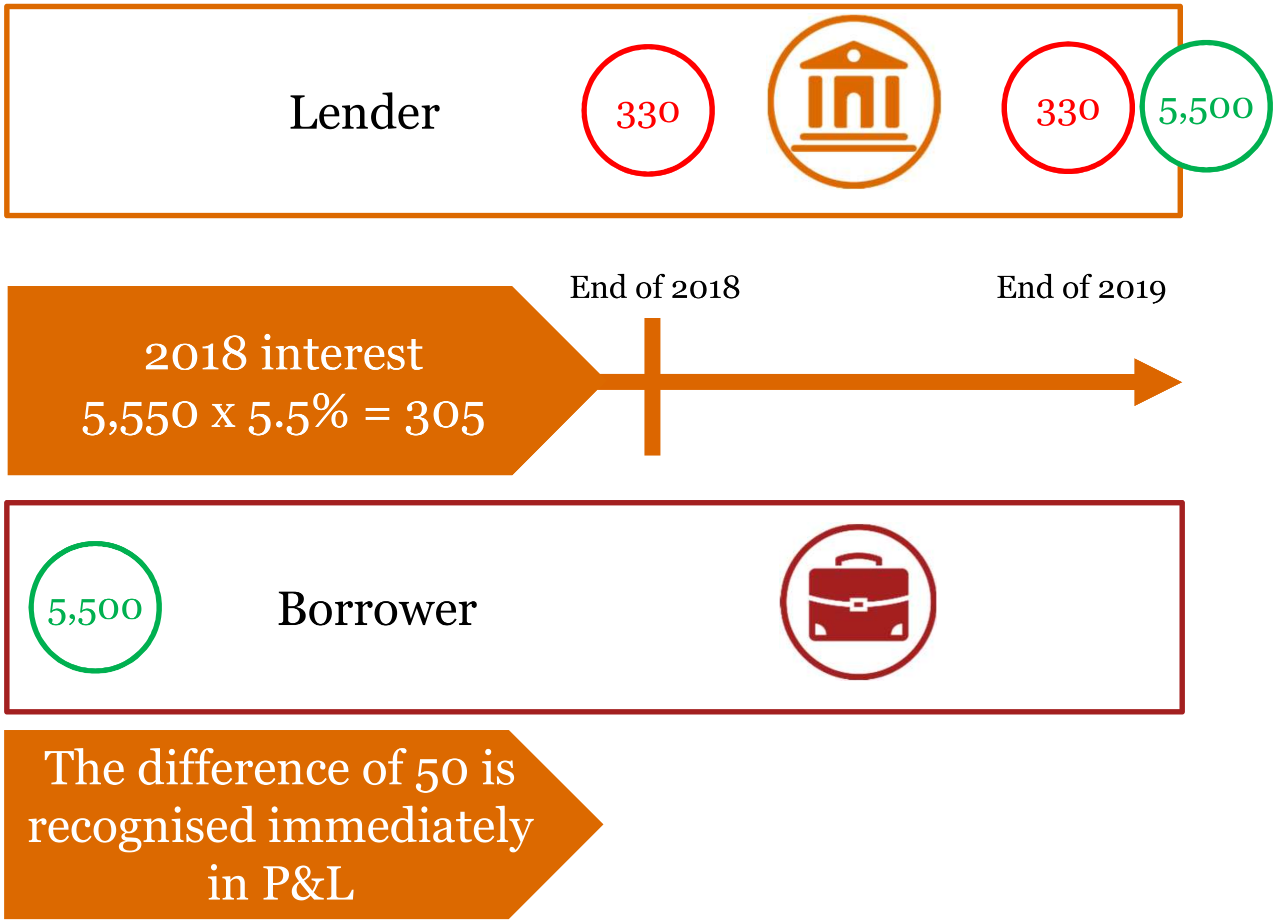
IFRS 9 para 5.4.3

Gain/loss using old EIR

What is the effect of the changes?

Liability 3 – Renegotiation (para 5.4.3)

Discounting the new cash flows at 5.5% <u>will lead to a carrying value of USD 5,550</u>



Lender

330

330

5,500

End of 2018

End of 2019

2018 interest
5,550 x 5.5% = 305

5,500

Borrower

The difference of 50 is recognised immediately in P&L

Question 2

An entity issues a profit participating loan. The loan's coupon payments are set as a percentage of the borrower's net profits.

Which guidance in IFRS 9 applies when the estimated future cash flows of the loan change?

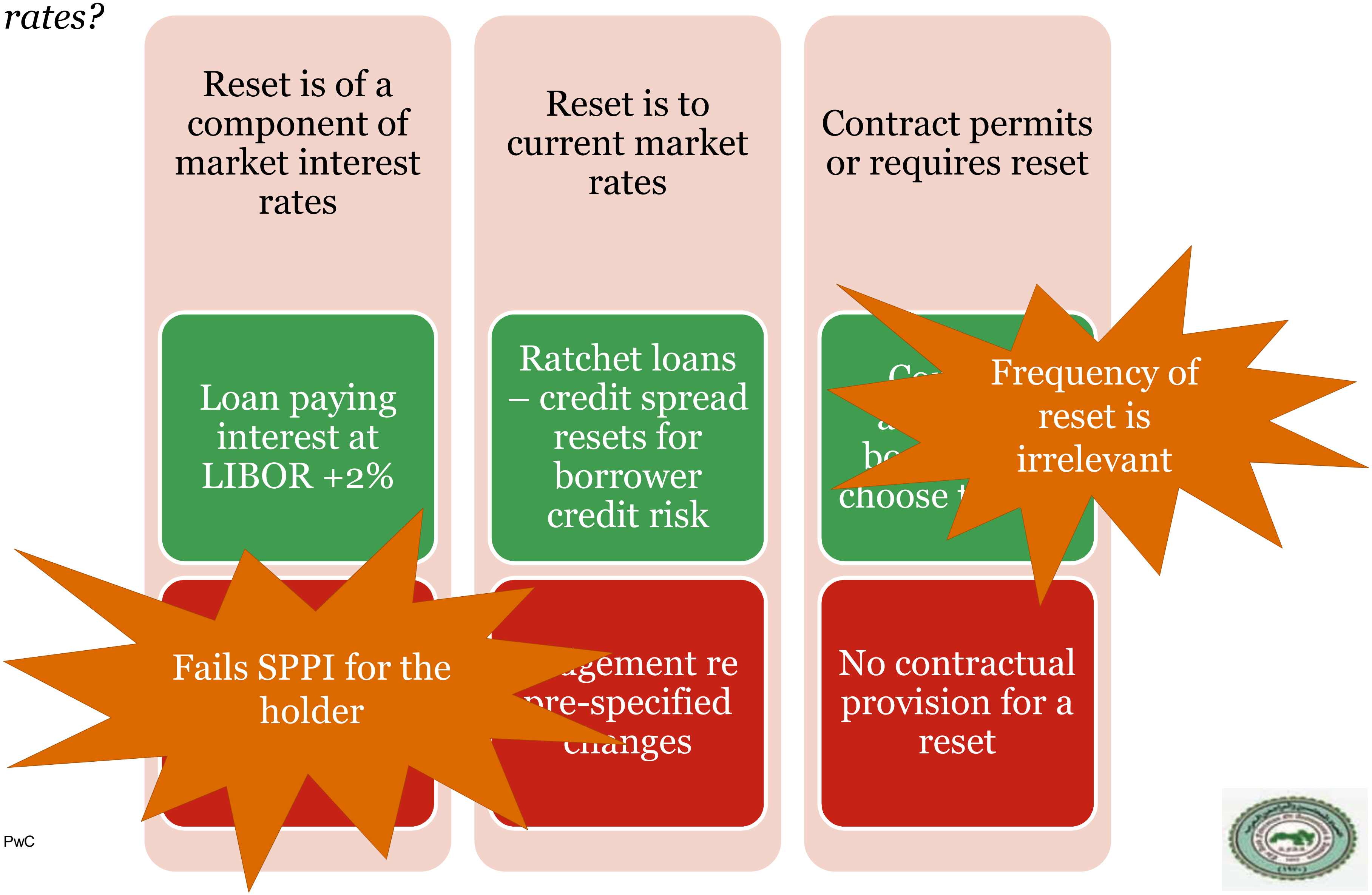
A –Floating rate loan – reset EIR (B5.4.5)

B –Other change – gain/loss using old EIR (B5.4.6)

C – Policy choice

Accounting for changes to cash flows of debt instruments

Recap - When does a change in cash flow reflect movements in market interest rates?



Reset is of a component of market interest rates

Loan paying interest at LIBOR +2%

Fails SPPI for the holder

Reset is to current market rates

Ratchet loans – credit spread resets for borrower credit risk

agement re pre-specified changes

Contract permits or requires reset

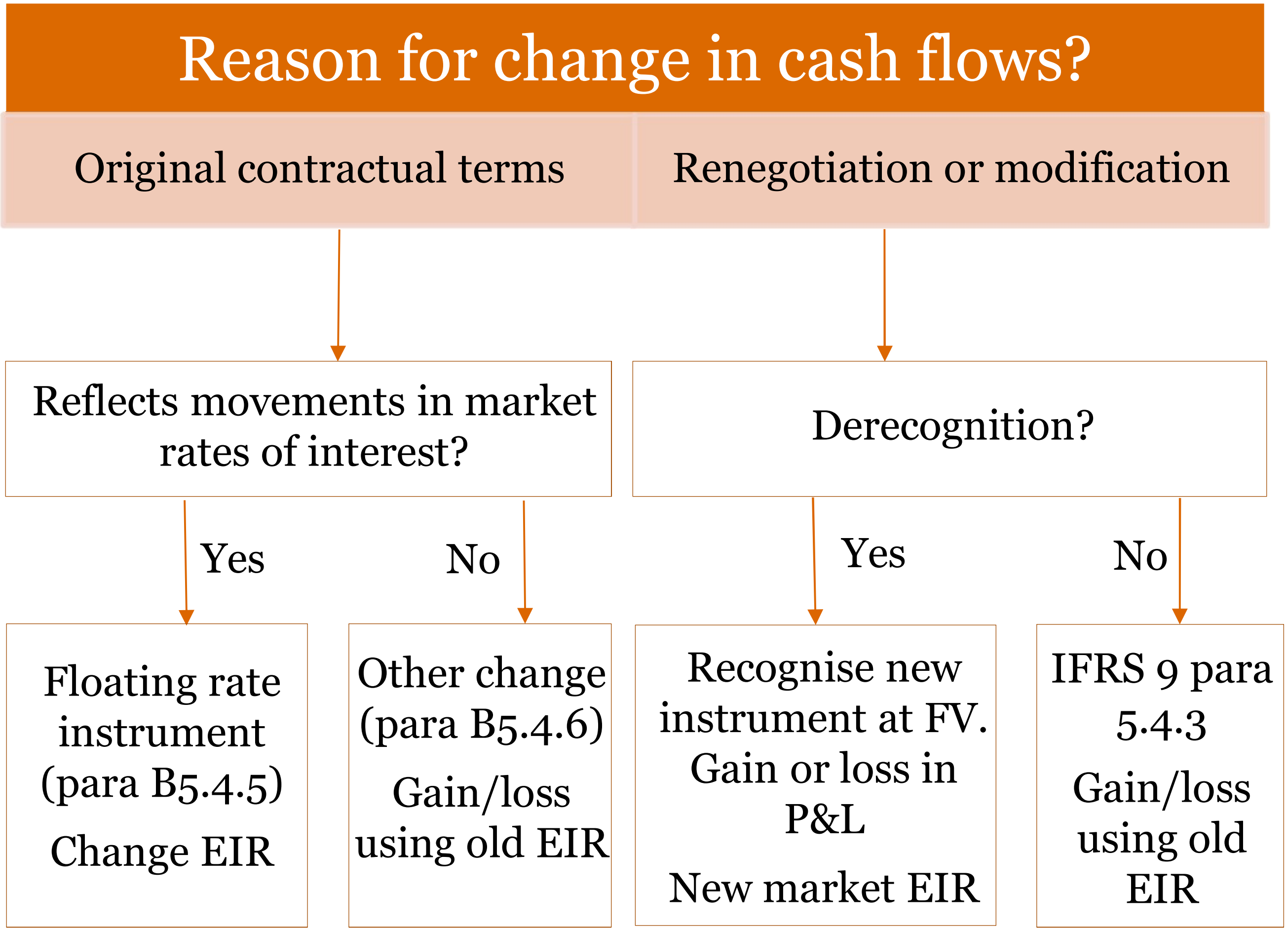
Co a bo choose t

Frequency of reset is irrelevant

No contractual provision for a reset

Accounting for changes to cash flows of debt instruments

Fees and costs?



Reason for change in cash flows?

Original contractual terms

Renegotiation or modification

Reflects movements in market rates of interest?

Derecognition?

Yes

No

Yes

No

Floating rate instrument (para B5.4.5)

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How should fees and costs be treated?

Accounting for changes to cash flows of debt instruments

Treatment of fees and costs of a debt renegotiation

Renegotiation results in derecognitio

- Recognised as part of the gain/los
extinguishment*

Same as changes to cash flows

Renegotiation does not result in derecognition

- Spread forward by adjusting the EIR

Different from changes to cash flows

*unless considered transaction costs of the new instrument

Accounting for changes to cash flows of debt instruments

Treatment of payments made – No derecognition

Reason for payments	**Modifying terms**	**Change in cash flows**
Example	Legal fees for the amended contract	Up-front payment made in return for reduced credit margin
Treatment	Spread forward by adjusting the EIR	Recognised immediately as part of the gain/loss on modification

Recap – treatment of changes in cash flows

Not contemplated in the original contract	Modification gain or loss recognised in P&L immediately
Contemplated in the contract and reflects a movement in market rates	EIR updated, no gain or loss
Other changes contemplated in the contract	Gain or loss recognised in P&L immediately
Fees and costs	Part of gain or loss on extinguishment, or spread forward if treated as a modification

Questions