DERECOGNITION FINANCIAL LIABILITIES

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Introduction

The provisions of Ind AS 109 with respect to the derecognition of financial liabilities are generally more straightforward and less subjective than those for the derecognition of financial assets.

However, they are also very different from the asset derecognition rules which focus primarily on the economic substance of the transaction.

By contrast, the rules for derecognition of liabilities, like the provisions of Ind AS 32 for the identification of instruments as financial liabilities, focus more on legal obligations than on economic substance .

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Derecognition of Financial Liabilities covers :-

1. the extinguishment of debt;

2. the substitution or modification of debt by the original lender; and

3. the calculation of any profit or loss arising on the derecognition of debt

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1 Extinguishment of debt

- Financial liability (or part of financial liability) is required to be derecognise (i.e. remove from its statement of financial position) when, and only when, it is 'extinguished', that is, when the obligation specified in the contract is discharged, cancelled, or expires.

- ***What constitutes 'part' of a liability?***
- *T*hese provisions are presumably also intended to apply in situations where an entity prepays the interest only (or a proportion of future interest payments) or the principal only (or a proportion of future principal payments) on a loan.

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Extinguishment of debt

Legal release by creditor

A liability can be derecognised by a debtor if the creditor legally releases the debtor from the liability.

Standard regards legal release as crucial, with the effect that very similar (if not identical) situations may lead to different results purely because of the legal form.

- where a debtor is legally released from a liability, derecognition is not precluded by the fact that the debtor has given a guarantee in respect of the liability; but
- if a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed the debt obligation, the debtor derecognises the debt obligation if, and only if, the creditor legally releases the debtor from its obligations.

The effect of these requirements is shown by Example

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Extinguishment of debt

Example: *Transfer of debt obligations with and without legal release*

- *Scenario 1*

  Entity A issues bonds that have a carrying amount and fair value of $1,000,000. A pays $1,000,000 to Entity B for B to assume responsibility for paying interest and principal on the bonds to the bondholders. The bondholders are informed that B has assumed responsibility for the debt. However, A is not legally released from the obligation to pay interest and principal by the bondholders. Accordingly, if B does not make payments when due, the bondholders may seek payment from A.

- *Scenario 2*

  Entity A issues bonds that have a carrying amount and fair value of $1,000,000. A pays $1,000,000 to Entity B for B to assume responsibility for paying interest and principal on the bonds to the bondholders. The bondholders are informed that B has assumed responsibility for the debt and legally release A from any further obligation under the debt. However, A enters into a guarantee arrangement whereby, if B does not make payments when due, the bondholders may seek payment from A.

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Extinguishment of debt

Scenario 1 is accounted for by the **continuing recognition** of the debt because no legal release has been obtained; but

Scenario 2 is accounted for by **derecognition of the debt**, and **recognition of the guarantee**, notwithstanding that the effect of the guarantee is to put A back in the same position as if it had not been released from its obligations under the original bond.

Legal release may also be achieved through the novation of a contract to an intermediary counterpart

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Extinguishment of debt

Extinguishment in exchange for transfer of assets not meeting the derecognition criteria

In such a case, the debtor will derecognise the liability from which it has been released, but recognise a new liability relating to the transferred assets that may be equal to the derecognised liability.

Example: An entity has a bank loan of €1 million. The bank agrees to accept in full payment of the loan transferred to it by the entity of a portfolio of corporate bonds with a market value of €1 million. The entity and the bank then enter into a put and call option over the bonds, the effect of which will be that the entity will repurchase the bonds in three years' time at a price that gives the bank a lender's return on €1 million

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Extinguishment of debt

Accounting Treatment

The entity would be able to derecognise the original bank loan, as it has been legally released from it.

But the new liability is recognised.

Effectively it tantamount that the entity has repaid the original loan and replaced it with a new one secured on a bond portfolio.

New loan is required to be initially recognised at fair value.

The difference will be gain or loss.

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2. Exchange or modification of debt by original lender

- ***Restructuring debt commitments , like***
- an agreement to postpone the repayment of principal in exchange for higher interest payments in the meantime, or
- to roll up interest into a single 'bullet' payment of interest and principal at the end of the term.

- These can be effected in a number of ways, in particular:
  - a notional repayment of the original loan followed by an immediate re-lending of all or part of the proceeds of the notional repayment as a new loan ('exchange'); or
  - legal amendment of the original loan agreement ('modification').

- The question arises whether there is, in fact, anything to account for.

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Exchange or modification of debt by original lender – Whether continuation or extinguishment ?

- If 'substantially different' terms or substantial modification
- To be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
- When to be considered as substantially modified.
- If the net present value of the cash flows under the new (including any fees paid net of any fees received) discounted at the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original debt instrument. Like for like.
- This comparisons commonly referred to as **'the 10% test'**.

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What if 10% test is not met ?

- No explicit prohibition if NPV of cash flow is less than 10%
- In many cases where the modification of the debt is so fundamental that immediate derecognition is appropriate whether or not the 10% test is satisfied.

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Exchange or modification of debt by original lender – costs and fees

- If an exchange of debt instruments or modification of terms is accounted for as an extinguishment of the original debt, any costs or fees incurred to be recognised as part of the gain or loss on the extinguishment.

- Where the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

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Exchange or modification of debt by original lender

Modification gains and losses

The standard is clear that modifications to the contractual cash flows of a financial asset measured at amortised cost that do not result in derecognition of that asset give rise to a modification gain or loss.

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Exchange or modification of debt by original lender

Example: *Modification of debt not treated as extinguishment*

On 1 January 2012 an entity borrowed £100 million on, at that time, arm's length market terms, so that interest of 7% was to be paid annually in arrears and the loan repaid in full on 31 December 2021. Transaction costs of £5 million were incurred.

Assuming that the loan had run to term, the entity would have recorded the following amounts using the effective interest method.

The loan is originally recorded at the issue proceeds of £100 million less transaction costs of £5 million, and the effective interest rate is 7.736%.

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Exchange or modification of debt by original lender

Year	Liability b/f	Interest at 7.736%	Cash paid	Liability c/f
1.1.2012	95.00			95
2012	95.00	7.35	(7.00)	95.35
2013	95.00	7.38	(7.00)	95.73
2014	95.73	7.40	(7.00)	96.13
2015	96.13	7.44	(7.00)	96.57
2016	96.57	7.47	(7.00)	97.04
2017	97.04	7.51	(7.00)	97.55
2018	97.55	7.55	(7.00)	98.10
2019	98.10	7.59	(7.00)	98.69
2020	98.69	7.63	(7.00)	99.32
2021	99.32	7.68	(107.00)	-

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Exchange or modification of debt by original lender

During 2016 the entity is in financial difficulties and approaches the lender for a modification of the terms of the loan.

These are agreed on 1 January 2017, as follows. No cash interest will be paid in 2017 or 2018, although a fee of £2 million must be paid to the lender immediately.

From 2019 onwards interest of 9% will be paid annually in arrears and the term of the loan will be extended for two years until 31 December 2023. Legal fees and other costs incurred are not material.

The entity is required to compute the present value of the new arrangement using the original effective interest rate of 7.736%. This gives a net present value for the modified debt of £92.53 million, calculated as follows:

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Exchange or modification of debt by original lender

Year	Cash Flow		Discount factor	
1.1.2017	Fee	2.00	1	2.00
2019	Interest	9.00	1/1.07736^3	7.20
2020	Interest	9.00	1/1.07736^4	6.68
2014	Interest	9.00	1/1.07736^5	6.20
2015	Interest	9.00	1/1.07736^6	5.75
2016	Interest and Principal	109.00	1/1.07736^7	64.70
Total				92.53

This represents 95.4% of the current carrying value of the debt as at the end of 2016 of £97.04 million, so that the net present value of the modified loan (discounted at the effective interest rate of the original loan) is 4.6% different from that of the original loan. This is less than 10%, **so that the modification is not automatically required to be treated as an extinguishment under Ind AS 109.**

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Exchange or modification of debt by original lender

If the entity selects an accounting policy to recognise modification gains or losses over the remaining term of the liability, the current carrying value of £97.04 million must stand and a new effective interest rate is derived.

New Borrowing

1. The carrying value of the loan at the end of 2016 of £97.04 million,
2. Less £2 million fees,
3. New borrowing £95.04 million,

is accounted for as follows, using a newly derived effective interest rate of 6.905%.

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Exchange or modification of debt by original lender

Year	Liability b/f	Interest at 6.905%	Cash paid	Liability c/f
2017	95.04	6.56		101.60
2018	101.60	7.01		108.61
2019	108.61	7.50	(9.00)	107.11
2020	107.11	7.40	(9.00)	105.51
2021	105.51	7.28	(9.00)	103.79
2022	103.79	7.17	(9.00)	101.96
2023	101.96	7.04	(109.00)	-

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Exchange or modification of debt by original lender

Example: *Modification of debt treated as extinguishment*

Assume the same facts as in Example except that on 1 January 2017 the entity comes to an arrangement with the lender to modify the terms of the loan as follows.

No cash interest will be paid in 2017 or 2018, although a fee of £2 million must be paid to the lender immediately. From 2019 onwards interest of 12.5% will be paid annually in arrears, and the term of the loan will be extended for three years until 31 December 2024. Legal fees and other costs incurred are not material.

As in Example above, the entity is required to compute the net present value of the new arrangement using the original effective interest rate of 7.736%.

This gives a net present value for the modified debt of £107.3 million calculated as follows.

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Exchange or modification of debt by original lender

Year	Cash Flow		Discount factor	
1.1.2017	Fee	2.00	1	2.00
2019	Interest	12.50	1/1.07736^3	10.00
2020	Interest	12.50	1/1.07736^4	9.28
2021	Interest	12.50	1/1.07736^5	8.61
2022	Interest	12.50	1/1.07736^6	7.99
2023	Interest	12.50	1/1.07736^7	7.42
2024	Interest and Principal	112.50	1/1.07736^8	61.98
Total				107.28

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Exchange or modification of debt by original lender

This represents 110.6% of the current carrying value of the debt as at the end of 2016 of £97.04 million. **This is greater than 10%, so that the modification is required to be treated as an extinguishment under IAS 39 and IFRS 9**.

This will involve derecognising the existing liability and recognising a new liability.

At what amount the new liability should be recognised. ?

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Exchange or modification of debt by original lender

The recognition of a new one, the modified loan must - in accordance with the initial measurement provisions of Ind AS 109 be recognised at fair value and amortised using its own effective interest rate.

The accounting treatment for the modification would be:

Particulars		Amount	Amount
Original Loan	Dr.	97.04	
Loss on extinguishment of debt (income statement)	Dr.	2.96	
Modified loan			98.00
Cash(fee)			2.00

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Exchange or modification of debt by original lender – Appendix D (in IFRIC 19 — *Extinguishing Financial Liabilities with Equity Instruments*

Settlement of financial liability with issue of new equity instrument.

Financial liability is derecognised ,

Equity is recognised

Difference is recognised in profit or loss

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Gains and losses on extinguishment of debt

The difference between the carrying amount of the transferred financial liability (or part of a liability) and

the consideration paid, including any non-cash assets transferred or liabilities assumed,

to be recognised in profit or loss.

If an entity repurchases only a part of a financial liability, it calculates the carrying value of the part disposed of (and hence the gain or loss on disposal) by allocating the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase.

In other words, the carrying amount of the liability is not simply reduced by consideration received.

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Gains and losses on extinguishment of debt

Example: *Partial derecognition of debt*

On 1 January 2014 an entity issues 500 million €1 10-year bonds which are traded in the capital market's. Issue costs of €15 million were incurred and the carrying value of the bonds at 31 December 2017 it €490 million. On 31 December 2017 the entity makes a market purchase of 120 million bonds at their then current market price of €0.97. The entity records the following accounting entry:

Particulars	Amount	Amount
Bonds(120/500*€490m) Dr.	117.60	
Cash(120m*€0.97)		116.40
Gain on repurchase of debt		1.20

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Gains and losses on extinguishment of debt

In some cases, a creditor may release a debtor from its present obligation to make payments, but the debtor assumes an obligation to pay if the party assuming primary responsibility defaults.

In such a case the debtor to recognise:

a) a new liability based on the fair value for the obligation for the guarantee; and
b) a gain or loss based on the difference between:
   i) any proceeds; and
   ii) the carrying amount of the original liability (including any related umamortised costs) less the fair value of the new liability.

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Good Luck

Thanks for the Patient hearing..

With Best Wishes .

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