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WHAT HAPPENS IF I RENEGOTIATE THE TERMS OF A LOAN?

In this edition of our ongoing series of views and commentary on FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland, Financial Reporting Faculty staff comment on the appropriate accounting when the terms of a loan are renegotiated. This publication replaces and updates the ICAEW Helpsheet on the same topic published in September 2015.

Question

I am in the process of renegotiating the terms of an existing loan. Some of the terms – such as the maturity date or the rate of interest payable – are likely to change significantly. Will this have any impact on my financial statements under FRS 102?

Answer

FRS 102 says that if an existing borrower and lender substantially modify the terms of an existing loan, they should account for the transaction as the extinguishment of the original loan and the recognition of a new one. In such circumstances, the difference between the carrying amount of the loan that has been extinguished and the consideration paid is recognised in profit or loss.

The standard does not define what is meant by 'substantially' different terms. This is therefore a matter of judgement. The guidance in AG62 of IAS 39 *Financial Instruments: Recognition and Measurement*, which might be referred to when making this judgement, suggests that a difference of greater than 10% is considered to be 'substantially different'. There is, however, no obligation to follow the international guidance.

Whatever threshold an entity chooses to apply, it will need to ensure that it is consistent in its approach to deciding what is and is not a substantial modification.

FRS 102 does not specify how to account for modifications that are **not** 'substantial'. One view is that the new carrying amount of the debt should be determined by computing the present value of the revised cash flows at the loan's original effective interest rate, with any adjustment recognised in profit or loss at the date of the revision, together with any fees incurred. This approach is illustrated in the example below. Other treatments may also be acceptable.

It is possible that a loan that was classified as 'basic' is replaced by one that does not meet the qualifying criteria and is therefore classified as an 'other' financial instrument, or vice versa. The terms of the new arrangement will therefore need to be examined closely.

APPENDIX – WORKED EXAMPLE

On 1 January 20X1, an entity takes out a bank loan for £5m, incurring an arrangement fee of £100,000. Interest of £400,000 is payable annually, in arrears, over the next four years. The loan is repayable on 31 December 20X4. The effective interest rate can be calculated as 8.6121%.

Assuming that the loan qualifies as a basic debt instrument, it would be accounted for using the amortised cost method as follows:

Year	Carrying amount at beginning of period £m	Interest expense at 8.6121% £m	Cash outflow £m	Carrying amount at end of period £m
20X1	4.900	0.422	(0.400)	4.922
20X2	4.922	0.424	(0.400)	4.946
20X3	4.946	0.426	(0.400)	4,972
20X4	4,972	0.428	(5.400)	-

On 31 December 20X1, the bank agreed to modify the terms of the loan so that it will not be repayable until the end of 20X6. Interest payments will, however, increase to the current market rate of £550,000 per annum. The lender charges a fee of £50,000 relating to the modification. For the purpose of this example, this fee is treated as being directly attributable to the issue of the new debt rather than the extinguishment of the old one.

The present value of the revised cash flows, including the modification fee, using the original effective interest rate of 8.6121%, can be calculated as £5.519m. This compares with the book value of the original loan as at 31 December 20X1 of £4.922m, a difference of £0.597m or 12.1%.

Substantial modification

If the entity concludes that the revised terms are substantially different to the old ones, it would derecognise the existing loan and recognise a new one. The difference between the carrying value of the old loan of £4.922m and the initial carrying value of the new loan at £4.950m (ie, £5m less the modification fee of £50,000) will give rise to a loss of £0.028m to be recognised in profit or loss.

The new loan, for which an effective interest rate can be calculated as 11.2724%, would then be accounted for as follows:

Year	Carrying amount at beginning of period £m	Interest expense at 11.2724% £m	Cash outflow £m	Carrying amount at end of period £m
20X2	4.950	0.558	(0.550)	4.958
20X3	4.958	0.559	(0.550)	4.967
20X4	4.967	0.560	(0.550)	4.977
20X5	4.977	0.561	(0.550)	4.988
20X6	4.988	0.562	(5.550)	-

Not a substantial modification

If the entity concludes – perhaps surprisingly in the circumstances – that this does not represent a substantial modification then there is no need to derecognise the existing loan. If the approach discussed on the first page of this update was adopted the difference between the current carrying value of the loan of £4.922m and the recalculated net present value, excluding the modification fee, of £5.469m would give rise to a loss of £0.547m to be recognised in profit or loss. The modification fee of £50,000 would be expensed as incurred.

The amortised cost method would then be applied to the adjusted carrying amount of the loan using its original effective interest rate as follows:

Year	Carrying amount at beginning of period £m	Interest expense at 8.6121% £m	Cash outflow £m	Carrying amount at end of period £m
20X1	4.900	0.422	(0.400)	4.922
20X2	5.469	0.471	(0.550)	5.390
20X3	5.390	0.464	(0.550)	5.304
20X4	5.304	0.457	(0.550)	5.211
20X5	5.211	0.449	(0.550)	5.110
20X6	5.110	0.440	(5.550)	-

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