STAFF PAPER

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IASB® meeting

Project	**IBOR Reform and its Effects on Financial Reporting – Phase 2**		
Paper topic	Sweep issue–Modification of financial instruments		

CONTACT(S)	Iliriana Feka	ifeka@ifrs.org	+44 (0) 20 7246 6482
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412

Purpose of this paper

1. The purpose of this paper is to consider a sweep issue related to a tentative decision that the Board made at its October 2019 meeting. Specifically, this paper considers the Board's tentative decision to amend IFRS 9 *Financial Instruments* to clarify that, even in the absence of an amendment to the contractual terms of a financial instrument, a change in the basis on which the contractual cash flows are determined that alters what was originally anticipated constitutes a modification of a financial instrument in accordance with IFRS 9.

2. This paper is structured as follows:

   (a) Tentative decision with respect to what constitutes a modification of a financial instrument (paragraph 3–7);

   (b) Staff analysis and concerns raised (paragraphs 8–12);

   (c) Question for the Board (page 5)

Tentative decision with respect to what constitutes a modification of a financial instrument

3. During the staff's research on the potential issues to be considered as part of Phase 2 and in the comment letters received on the Phase 1 Exposure Draft, stakeholders requested the Board clarify which changes to financial instruments constitute a modification in accordance with IFRS 9 and how to account for the changes to financial instruments arising from interest rate benchmark reform (IBOR reform).

4. Responding to that feedback, during its deliberations in October 2019 on the application of the requirements in IFRS 9 for modifications of financial instruments in the context of IBOR reform, the Board noted that in most cases it will be straightforward to determine whether a financial instrument has been modified; for example when the contractual terms of a financial instrument are amended to replace the existing interest rate benchmark with an alternative benchmark rate. However, the Board also acknowledged that, in some cases, there could be a change after the financial instrument is initially recognised in the basis on which the contractual cash flows are determined—and this may occur without an amendment to the contractual terms of the financial instrument. [1]

5. The Board further noted at that meeting that IFRS 9 does not define a 'modification of a financial instrument' but paragraph 5.4.3 of IFRS 9 refers to the modification of *contractual cash flows of a financial asset*, while paragraph 3.3.2 of IFRS 9 refers to the modification of *the terms of an existing financial liability*. Although these paragraphs use slightly different wording, both refer to a change in the contractual terms or contractual cash flows that was not specified/anticipated when the parties entered into the contract.

6. The staff also observed that applying the requirements in IFRS 9 for the modification of financial instruments only to changes in the contractual terms would imply that the form of the change is determinative, rather than the substance of the change. This could lead to situations where the economic effects of a change to the contractual cash flows are hidden or obscured by the legal form

[1] Agenda Paper 14A: Classification and measurement - modification of financial instruments

of the change. Accounting for a change in the basis on which the contractual cash flows are determined as a modification, even if the contractual terms of the financial instrument are not amended, would reflect the economic substance of such a change.

7. The Board therefore tentatively decided in October 2019 to propose an amendment to IFRS 9 to require that a change after the financial instrument is initially recognised in the basis on which the contractual cash flows are determined, constitutes the modification of the instrument even if the contractual terms of the instrument have not been amended. That proposed amendment would not be limited to modifications made in the context of IBOR reform, but rather the Board tentatively agreed that it would be proposed as a 'permanent' amendment to the requirements in IFRS 9 in order to avoid any diversity in practice that might arise due to the different wording in paragraphs 3.3.2 and 5.4.3 of IFRS 9.

Staff analysis and concerns raised

8. Following the Board's October 2019 meeting, the staff have been working on the possible structure and content of the Exposure Draft for Phase 2, including the proposed change to the text of IFRS 9 for the tentative decision described in paragraph 7. As the structure and wording of the existing requirements for modifications of financial assets are different from the requirements for modifications of financial liabilities—and the proposed amendment will have broader application than only changes in the context of IBOR reform— the staff is of the view that such a proposed amendment will require additional time and careful consideration to ensure that any unintended consequences are avoided. However, as noted by stakeholders, including some regulators, it is important to have clarity about how the existing requirements in IFRS 9 (and IAS 39 *Financial Instruments: Recognition and Measurement* for hedge accounting) would be applied in the context of IBOR reform, and to have any relief from specific requirements in IFRS 9 (and IAS 39 for the hedge accounting requirements) in place as soon as possible.

9. The staff therefore considered whether it would be possible, for the purpose of the upcoming Exposure Draft, to limit the scope of the proposed amendment described in paragraph 7, at this time, only to changes made in the context of IBOR reform. Following the completion of Phase 2, the Board could then proceed with proposing a narrow-scope amendment to the permanent structure of IFRS 9.

10. The staff noted that the objective of Phase 2 is to provide useful information to users of financial statements about the effect of the transition to alternative benchmark rates on an entity's financial statements and to support preparers in applying the requirements of IFRS Standards during IBOR reform. Therefore, limiting the scope of the amendment only to changes made in the context of IBOR reform is consistent with the objective of project.

11. Furthermore, as the Board is committed to finalising any relief associated with its tentative decisions as soon as possible (subject to appropriate due process), limiting the proposed amendments in the forthcoming Phase 2 Exposure Draft to the effects of IBOR reform will enable stakeholders to focus on assessing the proposals in that specific context, without being potentially distracted by proposals that have broader effects beyond the reform. The staff think this is particularly relevant if the Exposure Draft would have a shortened comment period (subject to the Board's decision on Agenda Paper 14E for this meeting). Some stakeholders have raised these considerations with the staff.

12. The staff therefore recommend that, for the purpose of Phase 2, the scope of the proposed amendment to clarify what constitutes a modification of a financial instrument, be limited only to changes made in the context of IBOR reform. However, separate from the Exposure Draft for Phase 2, the staff will proceed with the proposal to amend IFRS 9 to incorporate the amendment into the permanent requirements of IFRS 9 to address the lack of clarity that has been highlighted as a result of the analysis undertaken. The best time and context for that (for example whether it should be considered in the context of Annual Improvements) will be considered at a later date.

Question for the Board

Question for the Board
1) Does the Board agree with the staff recommendation that, for the purpose of Phase 2, the scope of the proposed amendment to clarify what constitutes a modification of a financial instrument, be limited only to changes made in the context of interest rate benchmark reform?