

Financial instruments

IFRS Newsletter



“The IASB has decided to improve its proposals on prepayment features and is on course to issue final amendments in October.”

- Chris Spall
KPMG’s global IFRS financial instruments leader

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The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in July 2017.

Highlights

Prepayment features with negative compensation

The Board completed its technical re-deliberations on the Exposure Draft (ED) *Prepayment Features with Negative Compensation*. After re-deliberating the eligibility conditions, it decided to:

- retain the first eligibility condition that the asset should be consistent with the ‘solely payments of principal and interest’ (SPPI) criterion except for the negative compensation feature;
- include a clarified explanation of its application in the basis for conclusions;
- remove the second eligibility condition – i.e. that the feature should have an insignificant fair value on initial recognition; and
- clarify that the existing exception for certain prepayment features at par would accommodate reasonable negative compensation.

After re-deliberating the effective date and transition provisions, the Board decided to:

- set the effective date of the amendments as annual periods beginning on or after 1 January 2019, with earlier application permitted; and
- require retrospective application subject to relevant IFRS 9 *Financial Instruments* transition provisions, including relief from restating comparatives, and particular disclosures.

The Board gave the staff permission to start the balloting process with a view to issuing final amendments in October 2017.

Modification or exchange of financial liabilities

The IASB staff presented its analysis of the main concerns and suggested a solution on how the Board could confirm the relevant accounting required by IFRS 9.

The Board decided to confirm the relevant accounting in the basis for conclusions that will accompany the amendments to IFRS 9.

Prepayment features with negative compensation

The story so far...

For a financial asset that is a debt instrument to be eligible for measurement at amortised cost or at fair value through other comprehensive income (FVOCI), IFRS 9 requires the contractual cash flows to meet the SPPI criterion.

For contractual terms that permit the borrower to prepay a debt instrument (or permit the lender to put a debt instrument back to the borrower before maturity), IFRS 9 states that the contractual cash flows meet the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may include reasonable additional compensation for early termination of the contract.

In [November 2016](#), the IFRS Interpretations Committee discussed the classification of debt instruments that include symmetric 'make-whole' prepayment options or fair value prepayment options. Most Committee members believed that such debt instruments fail to meet the SPPI criterion. This is because the borrower can choose to prepay and the lender can be forced to accept less than the amount of outstanding principal and interest. They believed that the SPPI criterion accommodates only instruments for which the party exercising its option to terminate the contract compensates, or pays a prepayment penalty to, the other party.

The Committee suggested that the Board consider whether using amortised cost measurement could provide useful information about particular financial assets with such prepayment features, and if so, consider changing the requirements of IFRS 9 in this area.

At its meeting in December 2016, the Board agreed to add a narrow-scope project to its agenda to consider amending IFRS 9 to allow particular financial assets with symmetric make-whole prepayment options to be measured at amortised cost or FVOCI.

In [January 2017](#), the Board discussed a narrow exception for symmetric prepayment options that would have met the existing prepayment requirements in IFRS 9 except for the fact that they could incur "reasonable negative compensation for the early termination of the contract". In addition, for a financial asset with such a symmetric prepayment option to be measured at amortised cost or FVOCI, the fair value of the prepayment feature should be insignificant on initial recognition of the asset.

Having agreed at its [February 2017 meeting](#) that an ED should be issued with a 30-day comment period, the Board then issued an ED in [April 2017](#) proposing a narrow-scope amendment to IFRS 9 – to allow financial assets with 'prepayment features with negative compensation' to be measured at amortised cost or FVOCI if certain conditions are met.

In [June 2017](#), the Board discussed the feedback received in comment letters on the ED and agreed on a project plan to re-deliberate key issues at the July Board meeting with a view to issuing final amendments in October 2017.

The Board agreed to retain the first eligibility condition, remove the second and make some additional clarifications.

Eligibility conditions

What's the issue?

The ED proposed that prepayable financial assets that would otherwise meet the SPPI criterion would be eligible to be measured at amortised cost or FVOCI – subject to the business model assessment – if the following conditions are met.

- The instrument is inconsistent with the SPPI criterion only because the party that chooses to terminate the contract early (or otherwise causes the early termination to occur) may receive reasonable additional compensation for doing so – referred to as the 'first eligibility condition'.
- The fair value of the prepayment feature is insignificant on initial recognition of the financial asset – referred to as the 'second eligibility condition'.

What was discussed in July?

First eligibility condition

When responding to the ED, most respondents agreed with the first eligibility condition and said that reasonable negative compensation for the early termination of the contract should not, in itself, prohibit a financial asset from qualifying for amortised cost measurement. However, many expressed concerns that the basis for conclusions to the ED seems to interpret or provide additional guidance on the meaning of 'reasonable additional compensation for the early termination of the contract'. These comments related to the classification of instruments that are prepayable at their current fair value and instruments that are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument.

The staff recommended retaining the first eligibility condition and believes that it is necessary to ensure the scope of the amendments targets a specific population of prepayable financial assets for which the effective interest method would provide useful information.

The staff believe that the notion of 'reasonable additional compensation for early termination of the contract' is important to the application of the first eligibility condition. Therefore, retaining an explanation in the basis for conclusions – relating to the classification of instruments that are prepayable at their current fair value or at an amount that includes the fair value cost to terminate an associated hedging instrument – is relevant to understanding the Board's intention for how the first eligibility condition would be applied and ensuring its consistent application.

However, the staff acknowledged that the wording in the basis for conclusions to the ED on this point may have been too absolute because there could be circumstances in which such prepayment amounts may be consistent with the notion of 'reasonable compensation for the early termination of a contract' – e.g. where the prepayment amount approximates unpaid amounts of principal and interest plus compensation for changes in the market benchmark interest rate only. They also noted that entities cannot automatically presume that all such instruments will meet the first eligibility condition or always be consistent with a notion of 'reasonable compensation for the early termination of a contract'. Rather, entities will need to make an assessment based on the instrument's specific contractual cash flow characteristics.

Second eligibility condition

Respondents had mixed views on the second eligibility condition. Some supported it but more than half disagreed and recommended that it be deleted. One of the reasons is that it would create asymmetry – i.e. IFRS 9 does not require entities to assess the fair value of prepayment features with positive compensation. Some respondents expressed the view that the second eligibility condition would not achieve the Board's stated objective, which is to restrict the scope of the amendments so that financial assets are eligible to be measured at amortised cost only if it is unlikely that prepayment – and therefore negative compensation – will occur.

The staff explained that the second eligibility condition was intended to be a proxy to assess the likelihood of prepayment occurring. They believe that the second eligibility condition would, at least in some cases, achieve the Board's objective because the fair value of the prepayment feature would consider the likelihood of prepayment occurring.

However, the staff acknowledged that the second eligibility condition does not achieve the Board's objective in some circumstances. This is because:

- the fair value of the prepayment feature will also reflect the probability that positive compensation will occur and could be more than insignificant largely or entirely due to such positive compensation;
- if negative compensation is equally likely to arise as positive compensation, then the fair value as a whole could be insignificant even though the probability of negative compensation arising is high; and
- if the financial asset could be prepaid at an amount close to its current fair value, then the intrinsic value would be zero even though the probability of negative compensation occurring is high.

The staff also considered that the fair value of a prepayment feature embedded in a financial asset that is acquired subsequent to its origination may be more than insignificant if the relevant market interest rate has changed since origination.

Having considered all these factors, the staff recommended that the Board remove the second eligibility condition (and the corresponding transition provision and disclosure requirement). They considered the potential benefits and challenges of the alternatives suggested by respondents but decided not to replace the second eligibility condition with any of those.

If the second eligibility condition is removed, then the accounting for negative and positive compensation would be aligned. The staff believes that a logical consequence of this would be that the existing exception for certain prepayment features at par could also be applied to a financial asset that contains a prepayment feature with negative compensation.

If the second eligibility condition is not removed, the staff highlighted the need to address the following issues because there would be a difference between the requirements for reasonable positive compensation and reasonable negative compensation.

Refining the description of ‘negative compensation’

The first eligibility condition says that negative compensation arises when the party that chooses to terminate the contract early (or otherwise causes the early termination to occur) may receive reasonable additional compensation for doing so. The staff noted that this description does not consider the case where the triggering event is not caused by either party – i.e. early termination is caused by an external event such as a change in law or regulation. In such a case, the lender could be forced to terminate the contract early and accept a prepayment amount that is less than unpaid amounts of principal and interest. The staff believe that this case should be covered by the description of ‘negative compensation’ and noted that negative compensation arises whenever a party to the contract is forced to pay compensation for the early termination of the contract – i.e. paying such an amount is out of its control.

Interaction with the exception for certain prepayment features at par

The staff believe that a financial asset that contains a prepayment feature with negative compensation can also be eligible for the existing exception that is applicable to assets that are acquired at a premium or discount but are prepayable at the contractual par amount. The Board did not previously consider whether a single financial asset should be able to meet both exceptions. The staff noted that the existing exception applies only to financial assets that are unlikely to be prepaid – e.g. many purchased credit-impaired financial assets with contractual prepayment features. Therefore, if that exception accommodated prepayment features that may result in reasonable negative compensation, then it would capture only those prepayable financial assets that are very unlikely to actually result in such negative compensation.

What did the Board decide?

The Board agreed with the staff’s recommendations and decided to:

- retain the first eligibility condition;
- include a clarified explanation in the basis for conclusions on the classification of instruments prepayable at their current fair value or at an amount that includes the fair value cost to terminate an associated hedging instrument;
- remove the second eligibility condition, the corresponding transition provision and disclosure requirement; and
- clarify that the existing exception for certain prepayment features at par would accommodate reasonable negative compensation for the early termination of the contract.

KPMG insight

Prepayment at current fair value

The staff provided an example of prepayment at current fair value which may be consistent with the notion of 'reasonable compensation for the early termination of a contract' – specifically when the fair value prepayment amount will approximate unpaid amounts of principal and interest, and compensation for changes in the market benchmark interest rate only. However, the current fair value is usually determined by discounting the instrument's remaining contractual cash flows at a current market interest rate (inclusive of spreads for risks such as credit). It is not clear whether the staff would accept that such an amount may in some circumstances be consistent with the notion of 'reasonable compensation for the early termination of a contract'.

In addition, the staff's example seems to imply that 'unpaid amounts of principal and interest' refers to unpaid principal and accrued interest. We note that IFRS 9 does not discuss how the term 'unpaid amounts of principal and interest on the principal amount outstanding' should be interpreted or how these amounts should be calculated in this context. We believe that determining 'unpaid amounts of principal and interest' requires consideration of the economic characteristics of the contract and may require judgement.

Prepayment features at par

In its analysis, the staff referred to the exception for prepayment features at par if the entity paid a premium or received a discount because the fair value has changed since origination. The staff made two passing comments on this point, that:

- such an asset should be measured at FVTPL if the fair value of the prepayment feature is not insignificant; and
- the exception applies only to financial assets that are very unlikely to be prepaid.

However, there are cases where loans are acquired at a premium to par, repayable at par plus accrued interest, and prepayment is highly likely to occur. We believe that it is possible that a loan acquired at a premium – which is repayable at par only after a specified period of time following acquisition and where prepayment is highly likely to occur – can meet the SPPI criterion. This is because if the premium is effectively repaid through coupon payments during the period before the prepayment date, then at the time when the prepayment option can and is expected to be exercised, a fixed prepayment amount may equal unpaid amounts of principal and interest.

The Board agreed to move the effective date to 1 January 2019 with retrospective application and transition requirements.

Effective date and transition provisions

What's the issue?

The ED proposed the same effective date as IFRS 9 – i.e. annual periods beginning on or after 1 January 2018. The proposed amendment would be applied retrospectively subject to a specific transitional provision related to the second eligibility condition. The transitional provision would apply if it was impracticable to measure the fair value of the prepayment feature on the basis of the facts and circumstances at initial recognition.

What was discussed in July?

Effective date

Respondents had mixed views on the proposed effective date. Many agreed with the proposal. However, some respondents (particularly those in jurisdictions with translation and/or endorsement processes) preferred a later effective date – i.e. annual periods beginning on or after 1 January 2019 with early application permitted. Even though the staff believe that there are significant benefits if entities initially apply IFRS 9 taking into account the effect of the amendments, due to the concerns raised by respondents, it recommended an effective date of 1 January 2019 with earlier application permitted.

Retrospective application

Most respondents supported the proposal to require retrospective application of the amendments. The staff therefore recommended applying the amendments retrospectively.

Transition provisions

Most respondents agreed with including the specific transition provision related to the second eligibility condition if that condition was retained. However, if the second eligibility condition is removed, the specific transition provision would not be necessary.

Some respondents who preferred a later effective date said that particular transition provisions in IFRS 9 – e.g. those related to the fair value option, applying the effective interest method, impairment and the relief from restating prior periods – should be made available again when an entity applies the amendments.

If the effective date is 1 January 2019, then the staff believe that entities applying the amendments for the first time after having already applied IFRS 9 may benefit from transition provisions related to:

- applying the effective interest method;
- applying the impairment requirements;
- assessing the business model (if an entity had not performed that assessment at the date of initial application of IFRS 9); and
- the fair value option for financial assets and financial liabilities.

This is because these transition provisions would assist entities where it is impracticable to apply particular requirements retrospectively and new assessments may be necessary because the amendments newly allow measurement at amortised cost or FVOCI.

The staff further recommended that entities would not be required to restate prior periods to reflect the effect of the amendments and could choose to do so only if it is possible without the use of hindsight.

Disclosures

The staff recommended disclosures that provide information to users of financial statements about changes in the classification and measurement of financial instruments as a result of applying the amendments.

The following information would need to be disclosed in the reporting period that an entity first applies the amendments, for each class of financial assets and financial liabilities as at the date that the entity first applies the amendments:

- the previous measurement category and carrying amount determined in accordance with IFRS 9;
- the new measurement category and carrying amount determined in accordance with the amendments;
- the carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated under the fair value option but are no longer so designated; and
- the reasons for any designation or de-designation of financial assets or financial liabilities under the fair value option.

What did the Board decide?

The Board agreed with the staff's recommendations and decided to:

- set the effective date of the amendments as annual periods beginning on or after 1 January 2019, with earlier application permitted; and
- require retrospective application with specific transition provisions and disclosures.

KPMG insight

1 January 2019 effective date

We expect that it is likely that entities that can early adopt the amendments will generally choose to do so, because they will probably consider the information more useful – and to avoid having to reclassify financial assets at a later date. A later effective date has benefits for entities in jurisdictions with endorsement and/or translation processes in cases where those processes are not completed in time for reporting in 2018. In such cases, those entities would be able to present a single set of financial information for 2018 that is compliant with both IFRSs as issued by the IASB and local jurisdictional requirements. However, entities that do not adopt the amendments until 2019 would before then still have to provide information about the possible impact of future adoption in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Transition disclosures

We expect that the specific disclosures required as at the date that the entity first applies the amendments will only be applicable in the event that the entity has already adopted IFRS 9 at an earlier date. For entities that early adopt the amendments at the same time that IFRS 9 is initially applied, similar disclosures are already required by paragraph 42I of IFRS 7 *Financial Instruments: Disclosures* but these involve comparing the measurement categories and carrying amounts under IFRS 9 to those under IAS 39 *Financial Instruments: Recognition and Measurement* or a prior version of IFRS 9.

Modification or exchange of financial liabilities

The story so far...

Modifications or exchanges of financial liabilities that do not result in derecognition are common. IFRS 9 (like IAS 39) requires that any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term. However, IFRS 9 does not explicitly specify the accounting for other changes in the contractual cash flows of the instrument, whereas IFRS 9 does for modifications of financial assets that do not result in derecognition.

The most common practice currently under IAS 39 is to recalculate the effective interest rate at the date of the modification without adjusting the amortised cost or recognising a gain or loss at the date of the modification.

This issue was therefore submitted to the IFRS Interpretations Committee to clarify whether an entity recognises a gain or loss in profit or loss for these modifications or exchanges of financial liabilities.

In November 2016 the Committee concluded that the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition.

At its [February 2017](#) meeting the Board discussed and agreed with the Committee's technical conclusions on the matter and also concluded that the principles and requirements in IFRS 9 provide an adequate basis to enable an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. So it objected to the Committee issuing a draft interpretation and supported an educative agenda decision, which would explain the accounting required by IFRS 9.

In March 2017, the Committee tentatively decided not to add this matter to its standard-setting agenda. Its tentative agenda decision stated that the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in the derecognition. The entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR) and recognises any adjustment to the amortised cost of the financial liability in profit or loss. The Committee also observed that, if an entity changes its accounting policy for such modifications or exchanges as a result of the initial application of IFRS 9, then the entity applies the transition requirements in IFRS 9, which require retrospective application subject to particular relief as specified in Section 7.2 of IFRS 9.

At its June 2017 meeting, the Committee discussed the comments received on the tentative agenda decision published in March 2017. The main concerns raised related to the applicability of paragraph B5.4.6 of IFRS 9, accounting for modification costs and fees incurred, complexities related to transition to IFRS 9 and the appropriateness of the chosen mechanism to address the matter. Although agreeing with the technical analysis in the tentative agenda decision, in the light of the comments received, the Committee decided not to finalise the agenda decision and instead referred the matter to the Board.

The Board decided to confirm the accounting required by IFRS 9.

What was discussed in July?

The staff presented to the Board its analysis of the main concerns raised in the comment letters on the Committee's tentative agenda decision and a suggested solution as to how the Board could confirm the relevant accounting required by IFRS 9.

Regarding applicability of paragraph B5.4.6 of IFRS 9, the staff said that they continue to agree with the previous conclusions of the Board and the Committee. In addition, they stated that paragraph B5.4.5 of IFRS 9 – which requires changing the EIR of floating-rate instruments to reflect re-estimation of cash flows due to changes in market interest rates – applies only to floating-rate instruments and that paragraph B5.4.6 of IFRS 9 applies to fixed-rate instruments.

Some respondents had raised concerns over the complexity of changing accounting policies retrospectively on transitioning to IFRS 9. However, the staff did not suggest a special transition requirement. They had noted in June 2017 that they did not see a compelling case for special transition requirements, adding that (under Section 7.2 of IFRS 9):

- the standard is not applied to items that already have been derecognised at the date of initial application;
- retrospective application of the requirements in paragraph B5.4.6 would be subject to impracticability relief; and
- entities need not restate prior periods.

The staff suggested that the Board highlight the accounting required by IFRS 9 for a modification of a financial liability that does not result in derecognition, specifically the applicability of paragraph B5.4.6.

What did the IASB decide?

The Board decided to describe the relevant accounting in the basis for conclusions that will accompany the amendments to IFRS 9 for prepayment features with negative compensation.

KPMG insight

Floating rate financial liabilities

The description of accounting that the staff proposes to include in the basis for conclusions to the amendments to IFRS 9 refers to the application of paragraph B5.4.6 of IFRS 9 to all revisions of estimated payments or receipts. Although the staff provided comments in its analysis regarding the applicability of paragraph B5.4.5 of IFRS 9 to floating-rate instruments, it is uncertain whether the Board will provide any clarity on this point.

Costs or fees incurred

The staff's proposed description does not mention the requirement in paragraph B3.3.6 of IFRS 9 that costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. Such costs or fees incurred need to:

- be excluded from the contractual cash flows accounted for in accordance with paragraph B5.4.6 of IFRS 9; and
 - adjust the EIR prospectively in accordance with paragraph B3.3.6 of IFRS 9.
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