In brief
A look at current financial reporting issues

13 October 2017

Amendments to IFRS 9: Prepayment Features with Negative Compensation and modifications of financial liabilities (Amendments to IFRS 9)

At a glance

The IASB ('Board') has issued a narrow-scope amendment to IFRS 9. The amendment covers two issues:

- What financial assets may be measured at amortised cost. The amendment permits more assets to be measured at amortised cost than under the previous version of IFRS 9, in particular some prepayable financial assets. It is likely to have the biggest impact on banks and other financial services entities and be broadly welcomed by companies.
- How to account for the modification of a financial liability. The amendment confirms that most such modifications will result in immediate recognition of a gain or loss. This is a change from common practice under IAS 39 today and will affect all kinds of entities that have renegotiated borrowings.

All companies should ensure that their projects to implement IFRS 9 identify what assets and transactions are or may be affected. Significant judgement may be required to apply the amendment, so early identification of the issues is advised.

Prepayment Features with Negative Compensation

Issue

The Board has issued a narrow-scope amendment to IFRS 9 to enable companies to measure at amortised cost some prepayable financial assets with negative compensation. The assets affected, that include some loans and debt securities, would otherwise have been measured at fair value through profit or loss (FVTPL).

Negative compensation arises where the contractual terms permit the borrower to prepay the instrument before its contractual maturity, but the prepayment amount could be less than unpaid amounts of principal and interest. However, to qualify for amortised cost measurement, the negative compensation[1] must be "*reasonable compensation for early termination of the contract*".

[1] That is, the difference between the prepayment amount and unpaid amounts of principal and interest.

An example of such reasonable compensation is an amount that reflects the effect of the change in the relevant benchmark rate of interest. However, the standard does not define 'reasonable compensation' and significant judgement may be required to assess if this test is met.

In addition, to qualify for amortised cost measurement, the asset must be held within a 'held to collect' business model.

Impact

The amendment is likely to be welcomed by preparers. In practice, there is a broad range of prepayment features with potentially negative compensation in many kinds of debt instruments:

- The prepayment option may be contingent on the occurrence of a trigger event (for example, sale or fall in value of collateral to a loan).
- The prepayment option may be held by only one party to the contract or both parties.
- Prepayment may be permitted or required (in particular circumstances).
- The compensation formula may differ. In many cases judgement will be required to assess whether the compensation meets the test of being "*reasonable compensation for early termination of the contract*".

Effective date

The amendment is effective for annual periods beginning on or after 1 January 2019, that is, one year later than the effective date of IFRS 9. Early adoption is permitted. This will enable companies to adopt the amendment when they first apply IFRS 9, though for companies in the EU early adoption will be subject to endorsement.

Modification of financial liabilities – IFRS 9 accounting change confirmed

As expected, the Board confirmed the accounting for modifications of financial liabilities under IFRS 9. That is, when a financial liability measured at amortised cost is modified without this resulting in derecognition, a gain or loss should be recognised in profit or loss. The gain or loss is calculated as the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate. This will impact all companies, particularly those applying a different policy for recognising gains and losses under IAS 39 today. Refer to prior In brief: Modification of financial liabilities – IFRS 9 changes accounting (March 2017).

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