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IFRS Developments

IASB issues an Amendment to IFRS 9

What you need to know

- The IASB has amended IFRS 9 to allow debt instruments with negative compensation prepayment features to be measured at amortised cost or fair value through other comprehensive income.
- The amendment is effective for annual reporting periods beginning on or after 1 January 2019, but earlier application is permitted.
- The IASB also clarified in the Basis for Conclusions that, under IFRS 9, gains and losses arising on modifications of financial liabilities that do not result in derecognition should be recognised in profit or loss.

Introduction

On 12 October 2017, the International Accounting Standards Board (IASB) issued an amendment to IFRS 9 *Financial Instruments* (the Amendment). This allows financial assets with prepayment features that permit or require a party to a contract either to pay or receive reasonable compensation for the early termination of the contract (so that, from the perspective of the holder of the asset there may be ‘negative compensation’), to be measured at amortised cost or at fair value through other comprehensive income.

Background

Under IFRS 9, a debt instrument can be measured at amortised cost or at fair value through other comprehensive income, provided that the contractual cash flows are ‘solely payments of principal and interest on the principal amount outstanding’ (the SPPI criterion) and the instrument is held within the appropriate business model for that classification.

Under IFRS 9, as published in 2014, contractual terms that permitted, or required, the early termination of contracts met the SPPI criterion only if the prepayment amount substantially represented unpaid amounts of principal and interest, which could include reasonable additional compensation for the early termination of the contract. This was generally interpreted as meaning that, to qualify as SPPI, the compensation or prepayment penalty must be paid by the party exercising the option to the other party, otherwise the payment would not be compensation.

An instrument with a contractual term that permits or requires *either* the borrower or the lender to prepay a loan before maturity at an amount which includes compensation for changes in the relevant benchmark interest rate would, therefore, have failed the SPPI criterion. This is because the lender could end up compensating the borrower (i.e., 'negative compensation'). For instance, if the current market interest rate is higher than the effective interest rate of the debt instrument, then a prepayment by the borrower would be less than the unpaid amount of principal and interest.

The IASB, when asked about such instruments, noted that:

- The terms of the financial instruments with prepayment features which allow negative compensation do not introduce different cash flows from financial instruments with other prepayment features
- The effective interest method can be applied to such instruments
- The amortised cost measurement can provide useful information about such instruments to users of the financial statements

The IASB therefore amended IFRS 9 to allow instruments with negative compensation features to meet the SPPI criterion.

Amendment

The Amendment to IFRS 9 clarifies that a financial asset passes the SPPI criterion regardless of the event or circumstance that cause the early termination of the contract and irrespective of which party pays or receives reasonable compensation for the early termination of the contract.

The Basis for Conclusions to the Amendment clarifies that the early termination can result from a contractual term or from an event outside the control of the parties to the contract, such as a change in law or regulation leading to the early termination of the contract.

The IASB had proposed a second eligibility condition for a negative compensation feature to satisfy the SPPI criterion in the Exposure Draft. This was that the fair value of the negative compensation prepayment feature should be insignificant when the entity initially recognised the instrument. However, the IASB did not include this requirement in the final Amendment.

Also, in the Basis for Conclusions, the IASB notes that some financial assets are prepayable at their current fair value and others are prepayable at an amount that includes the fair value of the cost to terminate an associated hedging instrument. The IASB acknowledges that there may be circumstances in which such features meet the SPPI criterion. It provides, as an example, the case when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. However, the IASB also noted that this will not always be the case. Therefore, for such instruments, an entity will have to assess the specific contractual cash flows for these instruments rather than automatically assuming that they will meet the SPPI criterion.

How we see it

The Amendment is intended to apply where the prepayment amount approximates to unpaid amounts of principal and interest plus or minus an amount that reflects the change in a benchmark interest rate. This implies that prepayments at current fair value or at an amount that includes the fair value of the cost to terminate an associated hedging instrument, will normally satisfy the SPPI criterion only if other elements of the change in fair value, such as the effects of credit risk or liquidity, are small. Most likely, the costs to terminate a 'plain vanilla' interest rate swap that is collateralised, so as to minimise the credit risks for the parties to the swap, will meet this requirement.

Effective date and transition

The Amendment is mandatory for annual reporting periods beginning on or after 1 January 2019, with earlier application permitted. The Amendment is required to be applied retrospectively.

The Amendment provides specific transition provisions if it is only applied in 2019 rather than in 2018 with the remainder of IFRS 9:

- The entity must revoke its application of the fair value option if, as a result of the Amendment, an accounting mismatch no longer exists, and may newly designate a financial asset or liability to be measured at fair value though profit or loss if a new accounting mismatch is created.
- Restatement of prior periods is not required and is only permitted if such restatement is possible without the use of hindsight.
- Additional disclosures must be made to describe the effect of applying the Amendment and any changes to the use of the fair value option.

Modification or exchange of a financial liability that does not result in derecognition

In the Basis for Conclusions to the Amendment, the IASB also clarifies that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in derecognition are consistent with those applied to the modification of a financial asset that does not result in derecognition. In other words, the gain or loss arising on modification of a financial liability that does not result in derecognition, calculated by discounting the change in contractual cash flows at the original effective interest rate, is immediately recognised in profit or loss.

The IASB made this comment in the Basis for Conclusions to the Amendment as it felt that the existing requirements in IFRS 9 provided an adequate basis for entities to account for modifications and exchanges of financial liabilities and that no formal amendment to IFRS 9 was needed in respect of this issue.

How we see it

The IASB states specifically that this clarification relates to the application of IFRS 9. As such, it would not appear that this clarification needs to be applied to the accounting for modification of liabilities under IAS 39 *Financial Instruments: Recognition and Measurement.*

Any entities which have not applied this accounting under IAS 39 are therefore likely to have a change of accounting on transition. As there is no specific relief, this change would need to be made retrospectively.

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