Prepayment features with negative compensation

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Proposed narrow-scope amendment to IFRS 9 for particular financial assets

Highlights

- What's the issue?
- Proposal to measure at amortised cost or FVOCI
- Next steps

Financial assets with 'prepayment features with negative compensation' would be measured at fair value through profit or loss (FVTPL) under current IFRS 9 *Financial Instruments*. But the IASB believes this would not be appropriate if amortised cost would provide useful information.

The IASB has issued an exposure draft (ED) proposing a narrow-scope amendment to IFRS 9 that would allow these financial assets to be measured at amortised cost or at fair value through other comprehensive income (FVOCI) if certain conditions are met.

What's the issue?

For a debt instrument to be eligible for measurement at amortised cost or FVOCI, IFRS 9 requires the contractual cash flows to be 'solely payments of principal and interest' (SPPI).

A prepayment option in a financial asset meets the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest, which may include reasonable additional compensation for early termination of the contract.

'Reasonable additional compensation' implies that the party choosing to exercise its option to terminate the contract compensates the other party.

But some prepayment options could result in that other party being forced to accept negative compensation – e.g. the lender receives an amount less than the unpaid amounts of principal and interest if the borrower chooses to prepay.

Applying current IFRS 9 would result in these instruments being measured at FVTPL. The IASB believes this result would not be appropriate if amortised cost provides useful information.

"The proposal is likely to be welcomed by preparers, but the challenge will be for the Board to finalise the amendment before IFRS 9 becomes effective in a matter of months."

Chris Spall
KPMG's global IFRS financial instruments leader

Proposal to measure at amortised cost or FVOCI

The ED proposes an exception to these rules on prepayment for financial assets containing prepayment features with reasonable negative compensation.

Such financial assets could be measured at amortised cost or at FVOCI if they meet the other relevant requirements of IFRS 9.

To be eligible for the exception, the fair value of the prepayment feature would have to be insignificant on initial recognition of the asset. If this is impracticable to assess based on the facts and circumstances that existed on initial recognition of the asset, then the exception would not be available.

The ED also says that financial assets prepayable at current fair value would be measured at FVTPL. The same would apply if the prepayment amount includes the fair value cost to terminate a hedging instrument if the amount is inconsistent with the current IFRS 9 prepayment rules.

The proposed amendment would be effective for annual periods beginning on or after 1 January 2018 – the effective date of IFRS 9 – and retrospective application would be required.

Next steps

The Board intends to issue a final amendment in Q4 2017. For more detail, see Issue 36 of our IFRS Newsletter: Financial Instruments.

The IASB's comment deadline closed on 24 May 2017. Read our comment letter to learn more about KPMG's position.

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