IFRS 9 – Changes warranting immediate attention

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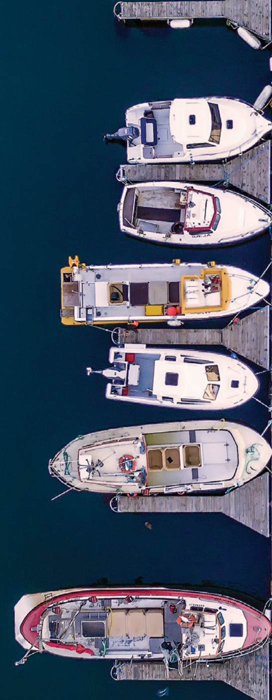

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Prepayment features with negative compensation and modifications of financial liabilities

Highlights

- IASB changes two areas of IFRS 9
- Prepayment features – 'Reasonable compensation' may be negative
- Modification of financial liabilities – Adjustments to profit or loss may be required
- Impacts for corporates and banks

The IASB has changed IFRS 9's requirements in two areas of financial instruments accounting. These changes could significantly affect companies preparing financial statements for 2017.

- Financial assets containing prepayment features with negative compensation can now be measured at amortised cost or at fair value through other comprehensive income (FVOCI) if they meet the other relevant requirements of IFRS 9.
- Companies that have modified or exchanged fixed rate financial liabilities face a significant change in the accounting for non-substantial modifications that do not result in derecognition.

Both changes could impact profit or loss. Companies need to reflect the impact of adopting IFRS 9 in the pre-implementation disclosures that they are required to include in their 2017 year-end financial statements.

"With IFRS 9's effective date only weeks away, all preparers – banks and corporates – should make it a priority to analyse the impact of these changes on their implementation projects."

Chris Spall
KPMG's global IFRS financial instruments leader

Prepayment features with negative compensation

For a debt instrument to be eligible for measurement at amortised cost or FVOCI, IFRS 9 requires its contractual cash flows to meet the SPPI criterion – i.e. the cash flows are 'solely payments of principal and interest'.

Under IFRS 9 (as issued in 2014), a prepayment option in a financial asset meets this 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.

Some prepayment options could result in the party that triggers the early termination receiving compensation from the other party (negative compensation) – e.g. a lender could receive an amount less than the unpaid amounts of principal and interest even though the borrower chooses to prepay. In other cases, an event outside the control of both parties may cause early termination.

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Applying IFRS 9 (as issued in 2014) would probably result in these instruments being measured at fair value through profit or loss (FVTPL). The Board believes this to be inappropriate because measuring them at amortised cost, using the effective interest method, provides useful information about the amount, timing and uncertainty of their future cash flows.

The amendment removes the word 'additional' so that negative compensation may be regarded as 'reasonable compensation' irrespective of the cause of the early termination. Financial assets with these prepayment features can therefore be measured at amortised cost or at FVOCI if they meet the other relevant requirements of IFRS 9.

The amendment is effective for annual periods beginning on or after 1 January 2019 with early adoption permitted. Retrospective application is required, subject to relevant transitional reliefs. Application of the amendment may be subject to local endorsement processes.

Modification of financial liabilities

Companies that have modified or exchanged fixed rate financial liabilities face a significant change in the accounting for non-substantial modifications that do not result in derecognition.

Common practice under IAS 39 *Financial Instruments: Recognition and Measurement* is to recalculate the effective interest rate (EIR) at the modification date to reflect the revised contractual cash flows, without recognising a gain or loss at that date.

The Board clarified that IFRS 9 (as issued in 2014) requires preparers to:

- recalculate the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original EIR; and
- recognise any adjustment in profit or loss.

The accounting treatment is therefore consistent with that required for modifications of financial assets that do not result in derecognition.

If the initial application of IFRS 9 results in a change in accounting policy for these modifications or exchanges, then retrospective application is required, subject to particular transitional reliefs.

There is no change to the accounting for costs and fees when a liability has been modified (but not substantially) – these are recognised as an adjustment to the carrying amount of the liability and are amortised over the remaining term of the modified liability.

Impacts and next steps

With the effective date of IFRS 9 only weeks away, companies should analyse the impact of these changes on their implementation projects. In particular, the classification of particular financial assets may need to change and adjustments to opening retained earnings may be required.

The changes will obviously impact banks, but corporates – i.e. non-financial sector companies – should also assess how the changes will affect them. Companies that have modified fixed rate financial instruments face a significant change in the accounting for non-substantial modifications because the accounting treatment differs from current practice and requires retrospective application.

Companies should also pay attention to the impact of the changes on their 2017 year-end financial statements, as they are required to reflect the impact of adopting IFRS 9 in their pre-implementation disclosures.

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