Prepayment features with Negative Compensation (Proposed Amendments to IFRS 9) - Cover Note

Objective

1 The objective of the session is to approve an updated draft comment letter on the exposure draft ED/2017/3 *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9)*, issued by the IASB in April 2017 (the 'ED').

Background

2 In April 2017, the IASB issued an ED to propose a narrow-scope amendment to IFRS 9 *Financial Instruments* so that a financial asset with a symmetric prepayment option would be eligible to be measured at amortised cost, or at fair value through other comprehensive income ('FVOCI') (subject to the business model condition) if the following conditions are met:

(a) the prepayment amount is inconsistent with paragraph B4.1.11(b) of IFRS 9 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; and

(b) the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset.

3 The IASB issued the ED with a comment period of 30 days, the due date being 24 May 2017.

Updating the draft comment letter

4 As advised by email, the written procedure was cancelled and replaced with a discussion at a public meeting. Based on the editorial comments received from EFRAG Board members during the written consultation period, the EFRAG Secretariat has updated the draft comment letter. In the following paragraphs, possible changes to the draft responses to question 2 and 3 are considered.

A Response to Question 2

5 In terms of the substantive issues raised by EFRAG Board members on the draft response to Question 2, the EFRAG Secretariat provides the following alternative views that could be expressed in the draft comment letter:

(a) Reject the second eligibility criterion, i.e. the requirement that when the entity initially recognises the financial asset, the fair value of the prepayment feature should be insignificant;

(b) Confirm the version of the draft comment letter that was written based on comments from EFRAG TEG and EFRAG FIWG members, i.e. supporting both eligibility criteria that accompany the proposed exception;

(c) Provide two views without conclusions and seek constituents' views; or

(d) Add an additional question to constituents regarding the second eligibility criterion without changing the version of the draft comment letter that was written based on comments from EFRAG TEG and EFRAG FIWG members.

6 The above alternatives have been developed hereafter.

Alternative A

7 Under Alternative A, paragraphs 13 – 21 would read as follows (new text is underlined).

EFRAG's response to question 2

> **EFRAG supports the proposal that financial instruments containing prepayment features with negative compensation could be eligible for measurement at amortised cost or at FVOCI. EFRAG assesses the negative sign of the reasonable compensation for early termination should not prevent measurement of a financial asset at amortised cost or FVOCI.**
>
> **<u>EFRAG agrees with the first eligibility criterion, but not with the second one as EFRAG sees no reason why the treatment of prepayment features with negative compensation should be aligned with prepayment options in financial assets that are acquired or originated at a premium or discount to the contractual amount</u>.**
>
> **In addition, EFRAG considers that the proposals should not be accompanied by references that interpret existing guidance in IFRS 9, including the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of other financial instruments, which is beyond the scope of the proposals in the Amendments.**

13 Amortised cost is a relatively simple measurement technique and is only applied to financial assets with contractual cash flows that are solely payments of principal and interest and should be consistent with a basic lending arrangement.

14 EFRAG has considered the SPPI test and has concluded that its application under IFRS 9 will generally lead to relevant information (i.e. amortised cost or fair value in the statement of financial position depending on the applicable business model). The SPPI test excludes instruments with contractual features giving rise to exposure to risks or fluctuations unrelated to a basic lending arrangement, such as leverage or changes in equity prices or commodity prices.

Assessing the first eligibility criterion

16 – 19 Unchanged.

Assessing the second eligibility criterion

20 <u>The aim of the second eligibility criterion is to limit the scope of the proposed exception by incorporating an estimate of the likelihood that prepayment (and consequently negative compensation) will occur. In other words, the election would not be available if the fair value of the prepayment feature would be significant at initial recognition. In that case, it is considered likely the prepayment feature is to be exercised and thus the financial asset would not be able to be measured at amortised cost or FVOCI.</u>

<u>21 EFRAG notes that, in accordance with paragraph B4.1.11(b) of IFRS 9, prepayment features are considered to result in contractual cash flows that are solely payments of principal and interest. Further, EFRAG recalls the guidance from IFRS 9 that all contingent features must be assessed in the</u>

same way. Consequently, the question can be raised why a prepayment feature with negative compensation is to be treated differently than one that provides reasonable additional compensation as permitted by paragraph B4.1.11 (b) of IFRS 9.

22 EFRAG acknowledges that the exception for prepayment features without negative compensation (in accordance with paragraph B4.1.12 of IFRS 9) are subject to the criterion that the fair value of the prepayment feature is insignificant at initial recognition. However, the additional condition has been justified in this case because it forms an exception to the general guidance.

23 EFRAG sees no reason why the conditions for applying the Amendments should align with an existing exception to the guidance, rather than with the general guidance. For this reason, EFRAG disagrees with the second eligibility criterion.

Overall assessment

24 EFRAG expects that preparers have already analysed which of their financial instruments pass the SPPI test as the implementation date of IFRS 9 is very close. EFRAG assesses that the proposals in the Amendments should not be accompanied by references that could interpret existing guidance in IFRS 9, including the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of other instruments, which is beyond the scope of the Amendments.

25 EFRAG agrees with the first eligibility criterion, but not with the second one as EFRAG sees no reason why the treatment of prepayment features with negative compensation should be aligned with prepayment options in financial assets that are acquired or originated at a premium or discount to the contractual amount.

26 EFRAG is concerned about potential spill-over effects of the Amendments, i.e. whether the eligibility criteria of the Amendments could affect financial instruments other than the ones intended. EFRAG is asking its constituents to provide evidence of this in responding to the Draft Comment Letter.

Alternative B

8 Conform the draft comment letter that was written based on comments from EFRAG TEG and EFRAG FIWG members (paper 01-02). The cover letter has been slightly adapted toning down the request for urgency from the IASB.

Alternative C

9 Provide Alternative B as View 1 and Alternative A as View 2 and express no preference. Constituents should be asked which View they prefer and their reason for that preference.

Alternative D

10 Issue the draft comment letter (agenda paper 01-02) and add the following question to constituents after paragraph 23.

Additional question to Constituents

11 With regard to the second eligibility criterion, is it common for financial assets to be issued with a prepayment feature whose fair value is significant at initial recognition that would otherwise pass the SPPI test? If so, please describe the features of such a financial asset.

Questions for EFRAG Board members

12 Which of the four alternatives do EFRAG Board members prefer?

B EFRAG's response to question 3

13 One EFRAG Board member raised a concern that the draft response to question 3 could be better phrased. The EFRAG Secretariat has developed an amendment to the draft comment letter to replace paragraphs 27-28 in agenda paper 01-02. The only practical solution to the timing problem that we can find is to make the proposed amendment to IFRS 9 an accounting policy option. The possible changes to the draft comment letter are underlined.

EFRAG supports a later effective date of 1 January 2019, with early application permitted. This will allow jurisdictions with translation and/or endorsement processes to finalise such processes before the mandatory effective date, while the possibility to early apply the Amendments provides preparers with the ability to implement soon after finalisation of any translation or endorsement process.

<u>EFRAG is of the view that the exception should become an accounting policy option as this would allow preparers to balance whether the change is worth the communication exercise related to it</u>.

27 EFRAG is concerned about the short time period between the expected date of issuing the proposed Amendments and the proposed effective date of 1 January 2018. EFRAG considers that this will create difficulties for all jurisdictions with a translation or endorsement process, including the EU, and it is highly unlikely that such processes can be finalised by 1 January 2018 in all jurisdictions.

28 Therefore, EFRAG strongly recommends that the IASB provide a later effective date of 1 January 2019, with early application permitted. This will allow jurisdictions with translation and/or endorsement processes to finalise such processes before the mandatory effective date of the Amendments. However, even if the effective date is deferred to 2019, entities in the EU that apply the Amendments at the due date would have to classify and measure financial assets containing such prepayment features at fair value through profit or loss when they first apply IFRS 9. Then, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, they will have to change the classification and measurement of those financial assets to amortised cost or FVOCI for those financial assets to which the final amendments apply.

29 <u>EFRAG considers such a change in accounting within a short timeframe not defendable from a business perspective. Preparers should have the ability to balance (i) the enhanced communication efforts relating to changing the measurement of financial instruments containing prepayment features with negative compensation and (ii) the impact of the measurement on their financial statements. EFRAG is of the view an accounting policy choice provides such a balance.</u>

Question to the EFRAG Board

14 Do you consider that this potential amendment is appropriate?

Final question to the EFRAG Board

15 Subject to the decisions on the questions above, do you approve the draft comment letter for publication?

Agenda Papers

16 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 01-02 Draft Comment Letter on IFRS 9 Amendments - Prepayment Features with Negative Compensation; and

(b) Agenda paper 01-03 IASB ED/2017/*3 Prepayment Features with Negative Compensation* (for background only).