

## IFRS in Focus

### IASB issues *Prepayment Features with Negative Compensation* (Amendments to IFRS 9)

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The International Accounting Standards Board (the IASB) has issued amendments to IFRS 9 *Financial Instruments* relating to prepayment features with negative compensation.

- The narrow-scope amendments remedy an unintended consequence to the notion of 'reasonable additional compensation'. The amendments allow financial assets with a prepayment option that could result in the option's holder *receiving* compensation for early termination to meet the SPPI condition if specified criteria are met.
- The amendment applies to annual periods beginning on or after 1 January 2019, with earlier application permitted.
- The package includes in the Basis for Conclusions the IASB's observations about the appropriate accounting for financial liabilities that are modified or exchanged but are not derecognised.

#### Background

Prior to this amendment, IFRS 9.B4.1.11(b) stated that the prepayment of a debt instrument at an amount that includes 'reasonable additional compensation' for the early termination of the instrument results in contractual cash flows that are solely payments of principal and interest ('SPPI') on the principal amount outstanding. A question arose in practice as to whether the concept of 'additional compensation' includes negative compensation, i.e. where the party exercising the option *receives* compensation from, as opposed to paying compensation to, the other party for early termination.

The compensation can be negative when both the borrower and the lender have an option to terminate a loan before maturity and the prepayment amount includes compensation that reflects the change in the relevant benchmark interest rate. Upon early termination, by either party, if the relevant benchmark interest rate has fallen since the loan was initially recognised, the lender will receive an amount representing the present value of that lost interest revenue over the loan's remaining term. Conversely, if the relevant benchmark interest rate has risen, the borrower will receive an amount that represents the effect of that change in that interest rate over the loan's remaining term. In practice, these amounts are netted against the principal amount due when the borrower repays the lender.

The IASB was concerned that in applying IFRS 9, these instruments would fail the SPPI condition and would need to be measured at FVTPL. Such prepayment features may exist in lending instruments, such as corporate loans and retail mortgages.

#### The amendments

The amendments to IFRS 9 clarify that for the purpose of assessing whether a prepayment feature meets the SPPI condition, the party exercising the option may pay **or** receive reasonable compensation for the prepayment irrespective of the reason for prepayment. In other words, prepayment features with negative compensation do not automatically fail SPPI.

For more information please see the following websites:

[www.iasplus.com](http://www.iasplus.com)

[www.deloitte.com](http://www.deloitte.com)

### **Observations**

In the Exposure Draft of the amendments, the IASB proposed that in addition to reasonable compensation, the fair value of the prepayment option should be insignificant on initial recognition in order for the financial asset to pass the SPPI test. The objective of including this second criterion was to limit the scope of the amendments to financial assets with negative prepayment features that are unlikely to be exercised (and thus have an insignificant fair value). However, feedback from respondents indicated that the second criterion is not effective in achieving the intended objective, mainly because the fair value of the entire prepayment feature does not reflect only the probability that negative compensation will occur, but also the probability and effect of any positive compensation occurring. Consequently, the IASB decided not to confirm the proposed second criterion when finalising the amendments.

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

At the time the prepayment options with negative compensation were being deliberated by the IASB they also considered the accounting for financial liabilities that are modified or exchanged that do not lead to derecognition. Specifically, whether a gain or loss arises from adjusting the amortised cost at the date of modification even though the liability is not derecognised. This issue arose from discussions with the IASB's Interpretations Committee. The Board took the opportunity in this amendment of IFRS 9 to include in the Basis for Conclusion two paragraphs on that matter. In those paragraphs the Board observes that the accounting in such cases is the same as it is for modifying a financial asset. If the gross carrying amount is changed it will lead to an immediate gain or loss in profit or loss.

### **Effective date and transition**

The amendments apply retrospectively to annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted. There are specific transition provisions depending on when the amendments are first applied, relative to the initial application of IFRS 9.

### **Further information**

The amendments and example are available on the IFRS Foundation website for holders of a professional or comprehensive eIFRS subscription. The amendments will be incorporated in the next updated set of unaccompanied Standards, which are available free of charge to registered users. That update is expected early in 2018.

If you have any questions about the amendments, please speak to your usual Deloitte contact or get in touch with a contact identified in this IFRS in Focus.

## Key contacts

### Global IFRS Leader

Veronica Poole  
ifrsglobalofficeuk@deloitte.co.uk

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## IFRS centres of excellence

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### Americas

Canada	Karen Higgins	ifrs@deloitte.ca
Mexico	Miguel Millan	mx-ifrs-coe@deloittemx.com
United States	Robert Uhl	iasplus-us@deloitte.com

### Asia-Pacific

Australia	Anna Crawford	ifrs@deloitte.com.au
China	Stephen Taylor	ifrs@deloitte.com.cn
Japan	Shinya Iwasaki	ifrs@tohatsu.co.jp
Singapore	James Xu	ifrs-sg@deloitte.com

### Europe-Africa

Belgium	Thomas Carlier	ifrs-belgium@deloitte.com
Denmark	Jan Peter Larsen	ifrs@deloitte.dk
France	Laurence Rivat	ifrs@deloitte.fr
Germany	Jens Berger	ifrs@deloitte.de
Italy	Massimiliano Semprini	ifrs-it@deloitte.it
Luxembourg	Eddy Termaten	ifrs@deloitte.lu
Netherlands	Ralph Ter Hoeven	ifrs@deloitte.nl
Russia	Maria Proshina	ifrs@deloitte.ru
South Africa	Nita Ranchod	ifrs@deloitte.co.za
Spain	Cleber Custodio	ifrs@deloitte.es
United Kingdom	Elizabeth Chrispin	deloitteifrs@deloitte.co.uk

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