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## **ED/2017/3 *Prepayment Features with Negative Compensation***

ICAEW welcomes the opportunity to comment on the ED/2017/3 *Prepayment Features with Negative Compensation*, published by the IASB on 21 April 2017, a copy of which is available from this [link](#).

This response of 23 May 2017 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 147,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

## MAJOR POINTS

### Change is needed but the proposals are overly complex

1. Following the IFRIC discussion on prepayment features with negative compensation, we strongly agree that this issue should be addressed and IFRS 9 clarified or amended as necessary to ensure appropriate classification of financial instruments with these features. We therefore welcome the IASB's efforts to address this issue promptly.
2. We are not, however, supportive of the IASB's proposed solution, which is overly complex, introduces unwelcome asymmetry and could result in unintended consequences. We believe that a better – and simpler – solution would be to clarify that the reference in paragraph B4.1.10(b) to 'reasonable compensation' encompasses both positive and negative compensation. This could, potentially, be introduced by simply adding a footnote to the aforementioned paragraph.
3. The advantage of this alternative is that it would retain IFRS 9's principles-based approach rather than introducing an exception to it. This would be helpful as it would avoid setting a dangerous precedent that could see the IASB receiving a flurry of further requests for exceptions.

### Avoiding unwelcome asymmetry

4. The first part of the exception, as drafted, would appear to be sufficient to solve the problem in hand. However, as noted above, our preferred solution is to simply clarify that 'reasonable compensation' encompasses both positive and negative compensation.
5. The second part of the exception is, however, more problematic. We are particularly concerned with the reference to the fair value of the prepayment feature being 'insignificant' at initial recognition. In our view the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation. Introducing such a clause would create unwelcome asymmetry.

### Avoiding unintended consequences

6. We are concerned that the basis for conclusions goes beyond the scope of the issue that the amendments are intended to address and in places appears to contradict the standard itself.
7. In particular, paragraphs BC 18 and BC20-24 seem to interpret IFRS 9's existing guidance on the meaning of 'reasonable compensation' in the context of prepayment options with positive compensation features. Doing so this close to the standard's effective date is only likely to cause confusion and consternation among preparers, many of whom will have already undertaken assessments based on the existing guidance. Moreover, it could inadvertently change how some instruments are classified. We therefore recommend deleting these paragraphs from the final basis for conclusions.
8. We also suggest that paragraph BC 19 is deleted. It suggests that paragraphs B4.1.12 and B4.1.12A of IFRS 9 are mutually exclusive. This is not set out in the standard itself and it seems illogical that a financial asset that is purchased after origination with a symmetric prepayment option, perhaps as a result of a business combination, should be required to be treated differently.
9. We recommend making these changes to the basis for conclusions regardless of which solution the IASB ultimately decides to proceed with.

## RESPONSES TO SPECIFIC QUESTIONS

### Question 1 – Addressing the concerns raised

Paragraphs BC3–BC6 describe the concerns raised about the classification of financial assets with particular prepayment features applying IFRS 9. The proposals in this Exposure Draft are designed to address these concerns.

Do you agree that the Board should seek to address these concerns? Why or why not?

11. Following the IFRIC discussion on prepayment features with negative compensation, we strongly agree that this issue should be addressed and IFRS 9 clarified or amended as necessary to ensure appropriate classification of financial instruments with these features. We therefore welcome the IASB's efforts to address this issue promptly.

### Question 2 – The proposed exception

The Exposure Draft proposes a narrow exception to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of a prepayment feature.

Specifically, the Exposure Draft proposes that such a financial asset would be eligible to be measured at amortised cost or at fair value through other comprehensive income, subject to the assessment of the business model in which it is held, if the following two 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) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

Do you agree with these conditions? Why or why not? If not, what conditions would you propose instead, and why?

12. Determining how a debt instrument will be classified under IFRS 9 will often involve significant judgement. Entities need to assess the contractual provisions of each instrument to determine whether cash flows are solely payments of principal and interest. This is often referred to as the SPPI test. Many basic lending arrangements will pass this test and will be measured at amortised cost or at fair value through other comprehensive income depending on the business model in which they are held. Other debt instruments will fail this test and will consequently be measured at fair value through profit or loss.
13. At present opinions are divided on whether instruments fail the SPPI test simply because of the existence of a negative compensation clause. Should they fail the test they will be measured at fair value through profit or loss. We do not, however, believe that this necessarily provides users of the financial statements with the most useful and meaningful information. We are therefore supportive of amending IFRS 9 to ensure that such instruments are more appropriately classified and measured.
14. We are not, however, supportive of the IASB's proposed solution, which is overly complex, introduces unwelcome asymmetry and could result in unintended consequences. We believe that a better – and simpler – solution would be to clarify that the reference in paragraph B4.1.10(b) to 'reasonable compensation' encompasses both positive and negative compensation ie, compensation that is either payable by or to the borrower. This could, potentially, be introduced by simply adding a footnote to the aforementioned paragraph.

15. The advantage of this alternative is that it would retain IFRS 9's principles-based approach rather than introducing an exception to it. This would be helpful as it would avoid setting a dangerous precedent that could see the IASB receiving a flurry of further requests for exceptions.
16. Turning now to the solution proposed by the IASB. The first part of the exception, as drafted, would appear to be sufficient to solve the problem in hand. However, as noted above, our preferred solution is to simply clarify that 'reasonable compensation' encompasses both positive and negative compensation. The second part of the exception is, however, more problematic. We are particularly concerned with the reference to the fair value of the prepayment feature being 'insignificant' at initial recognition. In our view the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation. Introducing such a clause would create unwelcome asymmetry. It could also give some counter-intuitive results in a business combination. For example, both the acquired entity and the counterparty might continue to pass the SPPI test while the acquiring group doesn't simply because markets have moved since the loan was issued
17. We are also concerned that certain elements of the basis for conclusions go beyond the scope of the issue that the amendments are intended to address and in places appear to contradict the standard itself.
18. In particular, paragraphs BC 18 and BC 20-24 interpret IFRS 9's existing guidance on the meaning of 'reasonable compensation' in the context of prepayment options with positive compensation features. Doing so this close to the standard's effective date is only likely to cause confusion and consternation among preparers, many of whom will have already undertaken assessments based on the existing guidance. Moreover, it could inadvertently change how some instruments are classified. We therefore recommend deleting these paragraphs from the final basis for conclusions.
19. We also suggest that paragraph BC 19 is deleted. It suggests that paragraphs B4.1.12 and B4.1.12A of IFRS 9 are mutually exclusive. This is not set out in the standard itself and it seems illogical that a financial asset that is purchased after origination with a symmetric prepayment option, perhaps as a result of a business combination, should be required to be treated differently.
20. We recommend making these changes to the basis for conclusions regardless of which solution the IASB ultimately decides to proceed with.

**Question 3 – Effective date**

**For the reasons set out in paragraphs BC25–BC26, the Exposure Draft proposes that the effective date of the exception would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018 with early application permitted.**

**Do you agree with this proposal? Why or why not? If you do not agree with the proposed effective date, what date would you propose instead and why? In particular, do you think a later effective date is more appropriate (with early application permitted) and, if so, why?**

21. We agree with an effective date of annual periods beginning on or after 1 January 2018 as it would be inefficient for entities to initially apply IFRS 9 without this exception and then be required to change the classification and measurement of certain financial assets when they apply the exception at a later date. Making the amendment as simple as possible by, for example, including the footnote suggested in paragraph 14 above, could make adoption and endorsement easier.

- 22.** We acknowledge that mandating this change at the eleventh hour may be disruptive for some entities and that in some instances it may be difficult to determine the effect of the proposed amendments before IFRS 9's effective date. Ensuring the amendments are endorsed in the EU and elsewhere ahead of the proposed effective date may also be challenging. This has resulted in some commentators calling for the effective date of the proposed amendments to be delayed until annual periods beginning on or after 1 January 2019. We do not agree with this suggestion. However, if the IASB were to decide to follow this path it is essential that early adoption is permitted so that those entities that wish to apply the exception in tandem with their initial adoption of IFRS 9 are able to do so.

**Question 4 – Transition**

**For the reasons set out in paragraphs BC27–BC28, the Exposure Draft proposes that the exception would be applied retrospectively, subject to a specific transition provision if doing so is impracticable.**

- (a) Do you agree with this proposal? Why or why not? If not, what would you propose instead and why?**

**As described in paragraphs BC30–BC31, the Exposure Draft does not propose any specific transition provisions for entities that apply IFRS 9 before they apply the exception.**

- (b) Do you think there are additional transition considerations that need to be specifically addressed for entities that apply IFRS 9 before they apply the amendments set out in the Exposure Draft? If so, what are those considerations?**

- 23.** We agree that the proposed amendments should be applied retrospectively unless doing so is impracticable. We note that transition provisions would not be required if the amendment were limited to the first criteria.
- 24.** We do not believe that any additional transitional provisions are needed for those entities that have adopted IFRS 9 early and will therefore be applying the proposed amendments subsequent to when they first applied IFRS 9.