This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Prepayment Features with Negative Compensation – Towards a DEA – Appendix II
Issues paper

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Relevance

1 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

2 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

3 In assessing relevance EFRAG has looked at the following issues:

(a) Prepayment features with negative and positive compensation;

(b) Amortised cost measurement or fair value through other comprehensive income ('FVOCI');

(c) Effective date of 1 January 2019 with early application; and

(d) Transition.

Prepayment features with negative and positive compensation

4 Currently, IFRS 9 *Financial Instruments* does not provide guidance whether a prepayable financial asset may be eligible to be measured at amortised cost or FVOCI if the party exercising its option to terminate the contract receives instead of pays compensation, also referred to as 'negative compensation'.

5 EFRAG notes that financial instruments that incorporate prepayment features with negative compensation do not introduce contractual cash flows payments of principal and interest that are different from the cash flows that may arise from financial instruments with positive compensation. It merely changes the circumstances in which the 'compensation' amounts could arise, and the potential sign of the compensation, by increasing the frequency of occurrence of contractual compensation amounts. Consequently, EFRAG considers that measurement at amortised cost or at FVOCI can provide relevant information for financial instruments with prepayment features with negative compensation.

Amortised cost measurement or FVOCI

6 The Amendments state that, in applying paragraphs B4.1.11(b) and B4.1.12(b) of IFRS 9, a financial asset that contains a prepayment amount that may result in negative compensation, would be eligible to be measured at amortised cost or at FVOCI, subject to the assessment of the business model in which it is held.

7 EFRAG acknowledges that the business model condition for:

(a) amortised cost reflects the objective of holding financial assets to collect their contractual cash flows; and

(b) FVOCI reflects the objective of both holding the financial assets and selling them.

8 Consistent with paragraph 5 above, EFRAG acknowledges that the contractual terms of financial instruments that incorporate prepayment features with negative compensation do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). That is, the financial instrument's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, the prepayment amount reflects unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate.

9 EFRAG therefore assesses that, as long as the business model condition in paragraph 7 has been met and the fair value option has not been elected, amortised cost provides relevant information about the expected credit loss and interest revenue calculated using the effective interest method. EFRAG assesses that the existence of a prepayment feature with negative compensation does not prevent a financial instrument from being a basic lending instrument, even when being held in a business model where performance is affected by both contractual cash flows and the realisation of fair value through sales. Hence, EFRAG assesses that FVOCI measurement can also provide relevant information for instruments with a prepayment feature with negative compensation.

Effective date of 1 January 2019 with early application

10 The Amendments are applicable for annual periods beginning on or after 1 January 2019, with earlier application permitted.

11 EFRAG assesses that early application will allow entities to apply the Amendments at the same time as IFRS 9 is applied. In such cases, where IFRS 9 and the Amendments are applied at the same time, it will lead to more relevant information as it allows entities to measure and present their financial instruments in line with their business model.

12 Where an entity does not early adopt the Amendments, EFRAG notes that these instruments might fail the solely payments of principal and interest ('SPPI') test. As a result, financial instruments that will be measured using amortised cost or FVOCI will need to be measured at fair value through profit or loss in accordance with IFRS 9. When the Amendments become applicable, entities would then have to revise their measurement of such instruments to amortised cost or FVOCI. EFRAG assess that the interim measurement of such instruments at fair value through profit or loss until the Amendment becomes applicable might restrict the relevance of information as fair value measurement might not be in line with the business model under which such instruments are being held.

13 However, EFRAG acknowledges that this is mitigated by the fact that:

(a) there is only one year between the effective date of IFRS 9 and the effective date of the Amendments; and

(b) when applying the Amendments for the first time, entities are required to disclose information about the previous carrying amount and measurement category of such instruments.

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14 Therefore, EFRAG assesses that the effective date of 1 January 2019, with early application permitted results in information that is relevant to users of the financial statements.

Transition

General

15 At transition, entities are required to apply the Amendments retrospectively unless impracticable. The same transition provisions in IFRS 9 would apply if the Amendments are applied when it initially applies IFRS 9, therefore no transition provisions are needed for the Amendments.

16 EFRAG considers that a retrospective approach provides the most relevant information for users because financial instruments that contain prepayment features with negative compensation will be accounted for as if they had always applied the Amendments.

Transition requirements for entities applying the Amendments for the first time after they apply IFRS 9

17 Specific transition provisions are provided for entities that will apply the Amendments after the initial application of IFRS 9, as the transition provisions in IFRS 9 would not be available in such cases. These specific transition provisions allow entities to newly designate, and require them to revoke their previous designation of, a financial asset at the date of initial application of the Amendments only to the extent that a new accounting mismatch is created, or a previous accounting mismatch no longer exists, as a result of applying the Amendments.

18 EFRAG considers that such transition requirements are necessary as the Amendments will ensure that entities classify and measure basic lending instruments containing prepayment features with negative compensation in accordance with the business model under which they are managed.

Conclusion

19 Overall, based on the above analysis, EFRAG concludes that the Amendments will result in relevant information.

Reliability

20 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

21 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

22 In assessing reliability EFRAG has looked at the issue of transition.

Transition

23 Entities that apply the Amendments after applying IFRS 9, are not required to restate prior periods to reflect the application of the Amendments. Entities may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in this Standard.

24 EFRAG notes that by not restating comparative information, the reliability of information could be reduced for an instrument that would have always been carried at an amortised cost taking into account the Amendments. However, EFRAG acknowledges that, in such cases, entities are required to calculate the carrying amount at the beginning of the annual period that includes the date of initial

application of the Amendments and recognise the difference between the new and previous carrying amount in either retained earnings or other component of equity, as appropriate.

25 EFRAG assesses that, as the difference in the carrying amount will be quantified and additional disclosures are required as part of the Amendments, users will have sufficient information available to evaluate the impact of the Amendments therefore the reliability of information provided is not reduced.

Question to EFRAG TEG

26 Do EFRAG TEG members agree the above issue affects primarily the reliability of the information or rather the comparability aspect of it? Please explain.

Conclusion

27 Overall, EFRAG concludes that the Amendments will result in reliable information.

Comparability

28 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

29 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

30 In assessing comparability EFRAG has looked at the following issues:

(a) Avoiding future diversity in practice;

(b) Prepayment features with negative and positive compensation;

(c) Transition requirements for entities applying the Amendments for the first time after they apply IFRS 9; and

(d) Effective date of 1 January 2019 with early application.

Avoiding future diversity in practice

31 EFRAG notes that the Amendments ensure that financial instruments with negative prepayment features are all accounted for in the same way. Without the clarification brought by the Amendments, the risk existed that diversity in practice could arise when implementing IFRS 9. EFRAG assesses that this contributes to comparability of the resulting accounting.

Prepayment features with negative and positive compensation

32 EFRAG notes that the Amendments align the eligibility criterion for prepayment features with negative compensation to those prepayment features with positive compensation. EFRAG assesses this as resulting in comparable information when measuring financial instruments with prepayment features. EFRAG notes that as long as the additional compensation for early termination of the contract is reasonable the sign of that compensation does not overrule the fact that the underlying financial instruments are comparable, as they do not introduce variability that is inconsistent with a basic lending agreement.

Transition requirements for entities applying the Amendments for the first time after they apply IFRS 9

33 Entities are provided with a choice as to whether to restate prior periods to reflect the application of the Amendments. However, EFRAG notes that restatement is not

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permitted when it cannot be applied without the use of hindsight. EFRAG also considers that disclosures around the measurement and recognition before and after applying the Amendments, irrespective of which option an entity chooses, mitigates the potential lack of comparability.

Effective date of 1 January 2019 with early application

34 The Amendments are to be applied as from the annual periods beginning on or after 1 January 2019 with earlier application permitted. This while IFRS 9 is being applied as from 1 January 2018.

35 It is argued by some that such an effective date may result in information to users of financial statements that is not comparable. The reason for this is that when endorsement is not completed by 1 January 2018 (or by the first filing in which IFRS 9 is applied), European entities would still need to apply the revised version of IFRS 9 soon after transitioning to the existing version.

36 EFRAG acknowledges this comment but notes that entities are required to disclose the known or reasonable estimable information relevant in assessing the possible impact of application of a new IFRS Standard will have on the entity's financial statements in the period of initial application.

37 EFRAG assesses that disclosing the impact of the Amendments on the entity's financial statements in the period of initial application can remove some of the concerns in making the changes comparable to users of financial statements. The reduction in comparability of information that remains is somewhat balanced by the fact that European entities that are SEC-filers would not have to publish two sets of financial statements.

Conclusion

38 Overall, EFRAG concludes that the Amendments lead to comparable information.

Understandability

39 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

40 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

41 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

42 EFRAG has not identified any issues that affect the understandability of the Amendments.

Prudence

43 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

44 Prudence is different from and unrelated to prudential reporting. The former is a qualitative characteristic used in accounting standard setting and is applicable to the financial statements of all companies. The latter refers to the reporting by individual financial institutions to regulators in order to meet the regulator's objectives (such as capital adequacy and liquidity).

45 EFRAG did not identify any aspects of the Amendments that would affect prudence.

True and Fair View Principle

46 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

47 Assessment of true and fair view to be developed.

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