IFRS news

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Amendments to IFRS 9: Prepayment features with negative compensation and modifications of financial liabilities

At a glance

The IASB ('Board') has issued a narrow-scope amendment to IFRS 9. The amendment covers two issues:

- What financial assets may be measured at amortised cost. The amendment permits more assets to be measured at amortised cost than under the previous version of IFRS 9, in particular some prepayable financial assets. It is likely to have the biggest impact on banks and other financial services entities and be broadly welcomed by companies.
- How to account for the modification of a financial liability. The amendment confirms that most such modifications will result in immediate recognition of a gain or loss. This is a change from common practice under IFRS 39 today and will affect all kinds of entities that have renegotiated borrowings.

All companies should ensure that their projects to implement IFRS 9 identify what assets and transactions are or may be affected. Significant judgement may be required to apply the amendment, so early identification of the issues is advised.

Prepayment features with negative compensation

Issue

The Board has issued a narrow-scope amendment to IFRS 9 to enable companies to measure at amortised cost some prepayable financial assets with negative compensation. The assets affected, that include some loans and debt securities, would otherwise have been measured at fair value through profit or loss (FVTPL).

Negative compensation arises where the contractual terms permit the borrower to prepay the instrument before its contractual maturity, but the prepayment amount could be less than unpaid amounts of principal and interest. However, to qualify for amortised cost measurement, the negative compensation[1] must be "*reasonable compensation for early termination of the contract*".

An example of such reasonable compensation is an amount that reflects the effect of the change in the relevant benchmark rate of interest. However, the standard does not define 'reasonable compensation' and significant judgement may be required to assess if this test is met.

In addition, to qualify for amortised cost measurement, the asset must be held within a 'held to collect' business model.

Impact

The amendment is likely to be welcomed by preparers. In practice, there is a broad range of prepayment features with potentially negative compensation in many kinds of debt instruments:

- The prepayment option may be contingent on the occurrence of a trigger event (for example, sale or fall in value of collateral to a loan).
- The prepayment option may be held by only one party to the contract or both parties.
- Prepayment may be permitted or required (in particular circumstances).
- The compensation formula may differ. In many cases judgement will be required to assess whether the compensation meets the test of being "*reasonable compensation for early termination of the contract*".

Effective date

The amendment is effective for annual periods beginning on or after 1 January 2019, that is, one year later than the effective date of IFRS 9. Early adoption is permitted. This will enable companies to adopt the amendment when they first apply IFRS 9, though for companies in the EU early adoption will be subject to endorsement.

Modification of financial liabilities IFRS 9 accounting change confirmed

As expected, the Board confirmed the accounting for modifications of financial liabilities under IFRS 9. That is, when a financial liability measured at amortised cost is modified without this resulting in derecognition, a gain or loss should be recognised in profit or loss. The gain or loss is calculated as the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate. This will impact all companies, particularly those applying a different policy for recognising gains and losses under IAS 39 today.

IFAS

Amendment to IFRS 9: 'Prepayment features with negative compensation' was adopted by DSAK-IAI as Amendment to SFAS 71. The amendment was approved on 26 July 2017. The amendment will be effective for the financial year started on or after 1 January 2020. Early adoption is permitted.

[1] That is, the difference between the prepayment amount and unpaid amounts of principal and interest.

IFRS IC decision on interest and penalties related to income taxes

Issue

The IFRS Interpretations Committee (IC) issued an agenda decision in September 2017 on interest and penalties related to in co me taxes.

IFRIC 23, 'Uncertainty over income tax treatments', applies to income taxes within the scope of IAS 12, 'Income taxes'. It does not address the accounting for interest and penalties. The IC considered whether it should develop guidance. The IC concluded that the benefits of improvements in financial reporting from a project to consider interest and penalties would not outweigh the costs. It therefore decided that it should not develop guidance, and it issued an agenda decision.

The IC observed in the agenda decision that entities do not have an accounting policy choice between applying IAS 12 and applying IAS 37, Provisions, contingent liabilities and contingent assets', to interest and penalties related to income taxes. If an entity considers that a particular amount payable or receivable for interest and penalties is an income tax, IAS 12 is applied to that amount. If an entity does not apply lAS 12 to an amount payable or receivable for interest and penalties, it applies IAS 37 to that amount.

The IC also observed that:

- an entity discloses its judgement in this respect applying paragraph 122 of IAS 1, 'Presentation of financial statements', if it has a significant effect on the amounts recognised in the financial statements; and
- regardless of whether an entity applies IAS 12 or IAS 37 when accounting for interest and penalties related to income taxes, the entity discloses information about those items if material, because both IAS 12 and IAS 37 provide disclosure requirements.

Impact

Who might be affected?

Any entities that receive or pay interest or penalties related to income taxes might be affected by the agenda decision.

What is the impact?

In the absence of specific guidance in IAS 12, some entities might currently make an accounting policy choice to determine whether IAS 12 or IAS 37 is applied to interest and penalties related to income tax where there are uncertain tax positions. These entities will now need to consider the specific nature of the interest and penalties to determine which standard applies. This might lead to recognition, measurement and disclosure differences in some cases and to a change in the way in which interest and penalties related to income taxes are presented in the income statement.

When is the agenda decision effective?

The agenda decision clarifies the existing guidance and is therefore effective immediately. Entities with a reporting date shortly after the agenda decision should assess whether the agenda decision applies at that date. The views of the relevant securities regulator should be considered as part of that assessment.

What should entities do?

Affected entities should assess their approach to accounting for interest and penalties related to income taxes, and they should consider whether their accounting policies and presentation need to be changed. Any change in accounting policy should be accounted for retrospectively in accordance with IAS 8, 'Accounting policies, changes in accounting estimates and errors'.

Insight

Applying IAS 37 rather than IAS 12 might lead to changes in recognition and measurement in some cases and would mean interest and penalties related to income taxes being presented differently in the income statement.

Entities need to decide whether a particular amount payable or receivable for interest and penalties is an income tax. IC agenda decisions in March 2006 and May 2009 noted that IAS 12 defines income taxes as taxes that are based on taxable profits, and the term 'taxable profit' implies a notion of a net rather than a gross amount. Amounts that are not based on taxable profits are not income taxes. For example, interest and penalties might not be separated from income taxes where there is an overall settlement with the tax authority and any interest and penalties cannot be identified separately.

Where can entities find more details?

See the September 2o17IFRICUpdate for the full agenda decision: www.ifrs.org/news-and-events/updates/ifric-updates/september-2017.

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