A. Prepayment Features with Negative Compensation

A1. Background
The International Accounting Standards Board (the “IASB”) responded to the uncertainty of classification of prepayable financial assets under IFRS 9: whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower to prepay the instrument at an amount that could be more or less than unpaid amounts of principal and interest?

In November 2017, the Financial Reporting Standards Committee of the Hong Kong Institute of Certified Public Accountants (the “HKICPA”) followed the clarification of the IASB and issued Amendments to HKFRS 9 – Financial Instruments: Prepayment Features with Negative Compensation.

A2. Financial assets can be classified as:

<table>
<thead>
<tr>
<th>Amortised cost</th>
<th>Fair value through other comprehensive income (“FVTOCI”)</th>
<th>Designated at fair value through profit or loss (“FVTPL”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not designated at FVTPL; Held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and Contractual terms of financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.</td>
<td>Held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and</td>
<td>Held within a business model whose objective is to realise cash flows through solely the sale of the asset.</td>
</tr>
</tbody>
</table>

Eliminate or significantly reduce accounting mismatch; and
A3. What is negative compensation?
Negative compensation is the difference between the prepayment amount and the unpaid amounts of principal and interest of the financial instrument. In some contractual arrangements, the borrower is permitted to prepay the financial instrument before its contractual maturity, and the prepayment amount could be less than the unpaid amounts of principal and interests.

A4. What is the issue?
The contractual cash flows of financial assets with negative compensation may not fulfill the condition of solely payments of principal and interest under HKFRS 9, and those instruments would be measured at FVTPL.

A5. What are the amendments?
The notion of “reasonable additional compensation” is changed to “reasonable compensation”. Paragraph B4.1.1(b) and B4.1.12(b) of HKFRS 9 will accommodate reasonable negative compensation for early termination of the contract without additional restrictions. The addition of paragraph B.4.1.12A allows payment or receipt of reasonable compensation, irrespective of the event or circumstance that causes early termination of the contract.

Prepayable financial asset with negative compensation is eligible to be measured at amortised cost or at FVTOCI, instead of at FVTPL, subject to the business model of the entity.

B. Modification or Exchange of Financial Liabilities

In December 2017, the HKICPA further updated the amendments to HKFRS 9 in respect of the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition. HKFRS 9 requires an entity to recalculate the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. Any adjustments to the amortised cost of the financial liability would be recognised in profit or loss at the date of the modification or exchange.

Effective Date
The amendments to HKFRS 9 shall be applied retrospectively for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted.

Transition
The transition provisions apply depend if the entity applies these amendments at the same time it first applies HKFRS 9.
A3. What is negative compensation?

Negative compensation is the difference between the prepayment amount and the unpaid amounts of principal and interest of the financial instrument. In some contractual arrangements, the borrower is permitted to prepay the financial instrument before its contractual maturity, and the prepayment amount could be less than the unpaid amounts of principal and interest.

A4. What is the issue?

The contractual cash flows of financial assets with negative compensation may not fulfill the condition of solely payments of principal and interest under HKFRS 9, and those instruments would be measured at FVTPL.

A5. What are the amendments?

The notion of “reasonable additional compensation” is changed to “reasonable compensation”. Paragraph B4.1.11(b) and B4.1.12(b) of HKFRS 9 will accommodate reasonable negative compensation for early termination of the contract without additional restrictions. The addition of paragraph B.4.1.12A allows payment or receipt of reasonable compensation, irrespective of the event or circumstance that causes early termination of the contract.

Prepayable financial asset with negative compensation is eligible to be measured at amortised cost or at FVTOCI, instead of at FVTPL, subject to the business model of the entity.

B. Modification or Exchange of Financial Liabilities

In December 2017, the HKICPA further updated the amendments to HKFRS 9 in respect of the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition.

HKFRS 9 requires an entity to recalculate the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. Any adjustments to the amortised cost of the financial liability would be recognised in profit or loss at the date of the modification or exchange.

Effective Date

The amendments to HKFRS 9 shall be applied retrospectively for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted.

Transition

The transition provisions apply depend if the entity applies these amendments at the same time it first applies HKFRS 9.