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REFERENCE: PREPAYMENT FEATURES WITH NEGATIVE COMPENSATION

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Standards Board)¹ welcomes the opportunity to respond to the Request for the ED/2017/03 Prepayment Features With Negative Compensation.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

We would like to congratulate the Board for its efforts to address the concerns of some interested parties about how IFRS 9 classifies particular prepayable financial assets.

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,



Silvio Takahashi
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)

¹The Brazilian Accounting Standards Board (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

QUESTIONS ON THE IASB'S ED/2017/03 PREPAYMENT FEATURES WITH NEGATIVE COMPENSATION.

The Board invites comments on the proposals in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

- (a) comment on the questions as stated;
- (b) indicate the specific paragraph(s) to which they relate;
- (c) contain a clear rationale; and
- (d) describe any alternative that the Board should consider, if applicable.

Comments should be submitted in writing to be received no later than 24 May 2017.

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?

Answer to question:

We agree that the Board should seek to address these concerns considering that IFRS 9 is a new standard, and considering that this situation can exist in different types of transactions in different jurisdictions. Doubts can be raised and different views and interpretation can be applied regarding the classification and measurement of financial instruments with particular prepayment features.

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?

Answer to question:

IFRS 9 determines the situations when the contractual terms allow the early termination of contracts and still meet the criteria of solely payments of principal and interest on the principal amount outstanding (SPPI criterion).

One of the SPPI criteria is that the prepayment amount might substantially represents unpaid amounts of principal and interest, which may include reasonable additional compensation for the early termination of the contract.

Regarding the first condition, CPC understand that in some circumstances, the party choosing to terminate the contract could force the lender to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest.

This results a payment to the borrower (i.e. negative compensation), included in the amount prepaid, instead of compensation from the borrower, even though the borrower chose to terminate the contract earlier than the contractual terms.

CPCs understands that the prepayment feature with negative compensation in the first scenario does not meet the SPPI criteria established in IFRS 9 due to the fact that this is not aligned with the overall interpretation that the prepayment penalty must be paid by the party exercising the option to the other party.

Related to the second condition CPC understand that being the fair value of the prepayment feature insignificant turn unlikely that the entity will exercise the prepayment option, and therefore there is a low probability that the negative compensation will occur.

Also, if the fair value of the prepayment feature is insignificant, usually, there is a non-significant impact in the measurement of the portfolio if the amortized cost or fair value through other comprehensive income approach is adopted.

CPC believes that prepayment features with negative compensation should be subject to the same eligibility conditions as prepayment features, taking into account the entity business model approach of IFRS 9 and the instruments with prepayment features with negative compensation should be eligible to be measured at amortized cost or fair value through other comprehensive income.

This approach brings true and fair view to the entities portfolio, something that would not be possible if those were measured at fair value through profit and loss.

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?

Answer to question:

Considering that the entities still have time to prepare themselves CPC agrees with this proposal as this instrument should be held within the appropriate business model and proper classified and measured when IFRS 9 is adopted. It seems to be inefficient for entities to initially apply IFRS 9 without this exception and then be required to change the classification and measurement of some prepayable financial assets after its adoption.

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?

Answer to question:

(a) We agree with this proposal as it seems to be reasonable to have the same transition requirements that has IFRS 9 for this exception, considering that it is related to an amendment of the standard and for most of the situation it does not seem to be impracticable to apply it retrospectively.

(b) No, we do not think that there would be necessary 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, as we agree that the exception would be applied retrospectively, and most of the entities would be able to do it even when they early applied IFRS 9.