

## STAFF PAPER

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## IASB® meeting

Project	Post-implementation review of IFRS 9— Classification and Measurement	
Paper topic	Amortised cost measurement and the effective interest method	
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## Introduction

1. At this meeting, the IASB will discuss *feedback to [Request for Information and comment letters: Post-implementation review of IFRS 9—Classification and Measurement](#)* (the RFI) regarding **amortised cost measurement and the effective interest method**.
2. This paper provides:
  - (a) a [summary of general feedback](#);
  - (b) [key application challenges](#);
  - (c) a reminder of the relevant [IFRS 9 requirements](#) in relation to amortised cost measurement and the effective interest method;
  - (d) [staff analysis and preliminary views](#) in relation to the key application challenges; and
  - (e) the following question for the IASB:

### Question for IASB

Do you have questions or comments about the feedback summarised or the preliminary staff views in this paper?

## Summary of general feedback

3. Most respondents to the RFI agreed that in applying IFRS 9, amortised cost provides useful information to users of financial statements about the amount, timing and uncertainty of future cash flows. Similar to the responses on modifications of financial assets and financial liabilities (see Agenda Paper 3A for this meeting), respondents acknowledged that the requirements for the effective interest method were carried forward from IAS 39 unchanged. However, they appreciated the opportunity to share their views and feedback on whether the requirements are able to be applied consistently.
4. Some respondents said that the effective interest method is working as intended and that the requirements are well understood. They are of the view that over time practice has become established and embedded in entities' processes and systems. These respondents are concerned that any potential amendments to the requirements would disrupt existing practice and involve significant costs for preparers to implement which would exceed any incremental benefit to be gained by the users of the financial statements.
5. In contrast, most respondents to this question said that the effective interest method is an area that gives rise to many questions in practice and for which the IASB could make helpful clarifications and provide additional application guidance. Respondents noted that the lack of guidance and clear principles to determine how to account for adjustments to contractual cash flows has led to a widespread number of accounting policies developed by preparers and accepted by auditors.

## Key application challenges

6. Respondents identified two key (albeit very broad) applications questions:
  - (a) how to reflect in the effective interest rate conditions attached to the contractual interest rate; and
  - (b) how to account for subsequent changes in estimates of future cash flows.
7. There is an interdependency between these application challenges because accounting for subsequent changes in estimates of future cash flows depends on an entity's

original estimates of future cash flows when calculating the effective interest rate (EIR) at initial recognition of the financial instrument. There might also be interaction with the expected credit loss requirements in IFRS 9, which will be subject to the upcoming post-implementation review of the impairment requirements in IFRS 9 *Financial Instruments* (see Agenda Paper 27 for this meeting).

***How to reflect conditions attached to the contractual interest rate?***

8. Respondents requested clarification on what expectations (or uncertainty) to consider in calculating the EIR and how to reflect conditionality attached to the contractual interest rate.
9. Most of the questions in this area were related to ‘behavioural’ features affecting the amount of contractual interest to be paid, for example an adjustment in the contractual interest rate based on the borrower’s performance in meeting lending or sustainability-linked targets.
10. In particular, respondents noted that the definition of the EIR refers ‘estimated future cash payments or receipts through the expected life of the financial asset or financial liability’ and asked for clarification on:
  - (a) *whether* estimated future cash payments or receipts should factor in conditional contractual terms such as specified adjustments to the contractual interest rate. Respondents commented that it could be difficult to determine a reliable estimate of future cash flows for more complex financial products; and
  - (b) if so, *how* such conditional terms should be considered in estimating cash flows through the expected life of the financial instrument. Those respondents stated that IFRS 9 is not clear on whether the entity uses a probability-weighted average (or expected value), the most likely or best estimate outcome or the statistical median when estimating future cash flows.
11. Respondents noted that recently more financial instruments have conditions attached to the contractual interest rate, such as financial assets with ESG-linked features and TLTRO III transactions. Respondents therefore consider this an area that will require significant judgement and that could lead to significant diversity in practice.

**How to reflect subsequent changes in estimates of future cash flows?**

12. Secondly respondents requested clarification on how to account for subsequent changes in estimates of contractual cash flows. More specifically, respondents asked for clarification on when subsequent changes in estimated cash flows are accounted for by adjusting the EIR (applying paragraph B5.4.5 of IFRS 9) or through a cumulative catch-up adjustment (applying paragraph B5.4.6 of IFRS 9).
13. Related to this question of application of paragraph B5.4.5 of IFRS 9 are:
  - (a) questions about the meaning of a ‘floating rate’ financial instrument and whether this refers to the overall contractual rate or only a component or element thereof; and
  - (b) the meaning of ‘movements in the market rates of interest’ and whether this includes any contractually specified adjustments to the contractual interest rate.
14. Most respondents agree that the standard example of a *floating rate instrument* is a loan referenced to a benchmark rate (for example, SONIA) with a fixed (credit) spread. However, respondents also frequently quote credit ratchet clauses (where the interest rate is reset to reflect changes in the credit spread of the borrower) as an example of the application of paragraph B5.4.5 of IFRS 9 to reset the EIR to the ‘market rates of interest’.
15. Following this view, respondents believe that ‘movements in the market rates of interest’ can relate to one or more of the different components that comprise the contractual interest rate and arise from both market-wide changes and changes arising from entity-specific factors relevant in determining the market rate of interest for an individual instrument. Furthermore, some respondents argued that while only a component of the rate may be reset to market rates (such as the benchmark interest rate), paragraph B5.4.5 does not only apply to this floating component. Rather, in their view, the overall contractual interest rate of such an instrument is considered a ‘market floating’ rate and any change in that rate is accounted for by adjusting the EIR.
16. A few respondents also questioned the interaction between the ‘movements in the market rates of interest’ (as per paragraph B5.4.5) and the ‘prevailing market rate(s)

of interest' used to determine the fair value of a financial instrument at initial recognition (as referred to in paragraph B5.1.1 of IFRS 9).

### ***Other application challenges***

17. Respondents also raised other areas that are related to the key issues discussed in paragraphs 6–16 and that would benefit from clarification, including:
  - (a) whether, and when, the EIR of a financial instrument is adjusted following a modification;
  - (b) how to account for any unamortised transaction costs or any fees received as part of a modification of financial assets and financial liabilities; and
  - (c) what the meaning of the phrase “fees and costs incurred” is in paragraph 5.4.3 of IFRS 9, in particular whether this includes fees received, fees paid and costs paid by both lender and the borrower (also see Agenda Paper 3A for this meeting).
  
18. The feedback mentioned in paragraph 17(a) above is similar to recent feedback received by the IFRS Interpretations Committee on the TLTRO III transactions and as part of the IBOR Reform—Phase 2 project. More specifically, stakeholders are asking how the reference to the ‘original EIR’ in paragraphs 5.4.3 and B5.4.6 should be interpreted in various situations, for example when:
  - (a) the benchmark interest rate is changed to another benchmark interest rate (outside of the IBOR reform), e.g. the benchmark interest rate is changed from SONIA to EONIA;
  - (b) a modification change to the contractual interest rate from a fixed to a floating rate (assuming the change is not substantial); or
  - (c) an entity satisfies the conditions attached to the contractual interest rate and the contractual interest rate is adjusted as specified in the contract.

## Relevant IFRS 9 requirements

### *Amortised cost measurement and the effective interest method*

19. IFRS 9 did not introduce new requirements pertaining to amortised cost measurement and the application of the effective interest method. These requirements were carried forward from IAS 39 largely unchanged.<sup>1</sup>
20. It is clear from the definition of the amortised cost of a financial asset or financial liability that the amortised cost at initial recognition is the fair value at initial recognition plus or minus any transaction costs as required by paragraph 5.1.1 of IFRS 9.
21. In applying the effective interest method, paragraph B5.4.1 requires an entity to identify fees that are an integral part of the EIR of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the EIR of a financial instrument are treated as an adjustment to the EIR unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

### *The effective interest rate*

#### *Determination of the effective interest rate at initial recognition*

22. Appendix A to IFRS 9 defines the EIR of a financial asset or financial liability as:
  - ... the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the EIR, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit

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<sup>1</sup> See [Agenda Paper 3A](#) of the March 2022 IASB meeting.

losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the EIR (see paragraphs B5.4.1–B5.4.3 of IFRS 9), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

*Subsequent changes to the effective interest rate and impact on amortised cost measurement*

23. The original effective interest rate is based on estimated future cash flows at initial recognition of a financial asset or financial liability as set out in paragraph 22 of this paper. Whether an entity updates the EIR over the life of an instrument depends on the applicable requirements in IFRS 9.
24. Paragraph B5.4.5 applies to floating rate financial instruments whose estimated future cash flows are revised to reflect the movements in the market rates of interest. Periodic re-estimations of such cash flows adjust the EIR.
25. The measurement principle as outlined in paragraph B5.4.6 of IFRS 9 applies to changes in estimated future cash flows in financial instruments other than those addressed in paragraph B5.4.5 of IFRS 9. Revisions of estimates cash flows for an instrument in the scope of paragraph B5.4.6 alter the gross carrying amount of the financial assets or the amortised cost of the financial liability by discounting the revised estimated cash flows at the financial instrument's original EIR. The resulting adjustment is recognised immediately as a gain or loss in profit or loss.

**Staff analysis and preliminary views**

26. The staff note that in particular the key application challenges reported through the PIR have not only arisen in practice since IFRS 9 was issued but have a long history

reaching back to 2008. Over the years several requests for clarification and/or additional guidance on the effective interest method have been submitted to the IFRS Interpretations Committee or have been considered by the IASB as part of other projects on IFRS 9, most notably the following:

- (a) May / October 2008 – Application of the Effective Interest Rate. The Committee referred the matter to the IASB which tentatively decided to address the matters raised through its Annual Improvement Process but never finalised its tentative decisions on the matter;
- (b) November 2009 - The IASB’s initial Exposure Draft *Financial Instruments: Amortised Cost and Impairment*. The exposure draft suggested to change the definition of the effective interest rate but was not finalised.
- (c) September 2013: Feedback on the IASB’s exposure draft *ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9*. Stakeholder provided feedback on amortised cost as measurement basis.
- (d) November 2016 to October 2017 – *Prepayment Features with Negative Compensation (Amendments to IFRS 9)*. The IASB expanded the use of amortised cost accounting to financial instruments which otherwise would have been measured at fair value through profit or loss.
- (e) June / November 2021- TLTRO III transactions (IFRS 9 and IAS 20) – The Committee received a request to clarify how to apply the effective interest method in cases where there is conditionality attached to the contractual interest rate. The Committee decided to refer the matter to the PIR of IFRS 9 on the classification and measurement requirements.

27. In addition, as a result of the post-implementation review of IFRS 9–Classification and Measurement, questions were raised as part of responses to modification of financial assets and financial liabilities how to determine the EIR in cases of particular modifications which did not lead to derecognition.



*Amortised cost measurement and the effective interest method*

28. The IASB's long-standing view has been that amortised cost provides useful information about some financial assets in particular circumstances because, for those assets, it provides information about the amount, timing and uncertainty of future cash flows. Amortised cost is calculated using the effective interest method which is a relatively simple measurement technique that allocates interest over the relevant time period using the EIR.<sup>2</sup>
29. The definition of the EIR in Appendix A of IFRS 9 (see also paragraph 22) is based on determining a single discount rate ie the effective yield or internal rate of return of a series of estimated cash flows, on initial recognition of the financial instrument. This discount rate is applicable for all periods throughout the life of a financial instrument. This means that at the point of calculation the EIR locks in an expectation about future cash flows for all periods. One important input factor in the determination of this single discount rate is the instrument's principal ie its fair value at initial recognition.<sup>3</sup>
30. This allocation mechanism is easy to apply and provides useful information (subject to business model) for financial assets with contractual cash flows that are fixed (ie known at initial recognition and not contingent). The allocation can also be performed for financial assets with variable contractual cash flows as long as those cash flows are reliably determinable. However, for a financial instrument with a variable interest rate, consideration must be given to the degree and sources of variability in cash flows in order to establish whether the amortised cost allocation mechanism would work well and provide complete and useful information.<sup>4</sup>

*How to reflect conditions attached to the contractual interest rate in the EIR?*

31. The effective interest rate (as defined in Appendix A of IFRS 9) is the rate that exactly discounts the estimated future cash flows to the gross carrying amount of a financial asset or amortised cost of a financial liability.

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<sup>2</sup> Paragraph BC 4.171 and BC4.172 of IFRS 9.

<sup>3</sup> Refer to paragraph B4.1.7B of IFRS 9.

<sup>4</sup> Refer to [Agenda Paper 6B](#) of the September 2013 IASB / FASB meeting.

32. Even before IFRS 9 became effective, stakeholders have been asking for clarification on what needs to be considered in estimating the expected cash flows over the life of the instruments. For example, on floating rate instruments, they have asked whether current expectations about the future changes in interest rates have to be considered in the calculation of the EIR. Another example commonly mentioned is whether an entity's expectations about the occurrence of a contingent event specified in the contract have to be considered, and how to do that.
33. The staff note that for floating rate financial instruments, the IASB tentatively decided in 2008 that current expectations about future interest rates (for example forward rates of a benchmark interest rate component) are not included in the estimates for the purposes of the EIR calculation. Therefore for the floating component of such an instrument would be estimated at the current floating spot rate of such a market-based variable rate. This view is further supported by example B.24 of the IFRS 9 Implementation Guidance.<sup>5</sup> However, this decision has not been finalised or reflected IAS 39 or IFRS 9.
34. When conditionality or contingent features attached to the contractual interest rate is not based on a market-based variable but on another variable (which is not considered to periodically reprice to market), the potential variability in the cash flows of an instrument increases further and therefore the uncertainty and complexity regarding the determination of the EIR increases.
35. Given the long-standing nature of stakeholder questions and the current diversity in practice that was confirmed in the comment letters on the recent IC Agenda Decision on the TLTRO III transactions, we are of the view that standard setting would be required in order to clarify when and how to reflect conditions attached to the contractual interest rate in determining the EIR.

*Application of paragraph B5.4.5 of IFRS 9*

36. Paragraph B5.4.5 of IFRS 9 applies to floating rate financial instruments whose estimated future cash flows are revised to reflect the movements in the market rates of

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<sup>5</sup> If in example B24 the discount rate ie the EIR was based on cash flows determined using the forward rates at initial recognition the present value of the future stream of cash flows would not equal a constant gross carrying amount in each period using the calculated EIR as a single discount rate over the life of the instrument.

interest ie are market-based variable rate financial instruments (the term market-based variable rate instrument is used in BCZ5.69 and example B.24 of the Implementation Guidance of IFRS 9).

37. When applying paragraph B5.4.5 of IFRS 9 the EIR of a financial instrument held at amortised cost is periodically adjusted when changes in the market rates occur (ie the market rates reset). On the other hand, paragraph B5.4.6 of IFRS 9 relies on the historic or original EIR determined on initial recognition to keep the effective yield recognised in net interest income constant and cumulatively adjusts the gross carrying amount of a financial assets or the amortised cost of a financial liability (ie catch-up adjustment) when expectations are revised.
38. As noted in paragraph 13 of this paper, respondents requested two key clarifications in order to determine the scope of paragraph B5.4.5 of IFRS 9:
- (a) what does the term '*market rates of interest*' refer to; and
  - (b) what is a '*floating rate*' financial asset or liability
- when applying paragraph B5.4.5 of IFRS 9.

#### *Market rates of interest*

39. The contractual interest rate for instruments eligible for amortised cost measurement consists for example of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin and/or other components compliant with the notion of a basic lending agreement. Consideration for the time value of money and the credit risk are typically the most significant elements of contractual interest.<sup>6</sup>
40. This is reflected in determining or pricing the contractual interest rate for an individual financial asset or financial liability. In most cases an entity prices such an instrument at market ie using the market rate of interest for that instrument. It is specific to that instrument because pricing such an instrument an entity usually considers a number of building blocks/elements or pricing/risk components which are related to general market-based variables (for example the risk free (benchmark)

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<sup>6</sup> Refer to paragraph BC4.182 (b) of IFRS 9.

reference rate) and specific other variables which are different to general market-based variables, for example a borrower specific credit spread.<sup>7</sup>

41. The aggregation of all of these pricing components identified equals the financial instrument's [prevailing] *market rate(s) of interest* at initial recognition. This is the market rate of interest as described in paragraphs B4.3.8 (b) or B5.1.1 of IFRS 9. This means the fair value as defined in paragraph 9 of IFRS 13 of this particular financial instrument in most instances equals the transaction price.
42. All of these interest rate variables or components might move after initial recognition. However, we think it is important to distinguish between:
  - (a) general movements in the market rates of interest (for example benchmark interest rates) not specific to a particular entity. Such movements therefore apply equally to all financial instruments with an interest rate referenced to such a market-based variable or floating rate, and
  - (b) changes in the market rate for a particular financial instrument that reflect entity-specific factors (such as changes in credit risk) in addition to general market movements in interest rates.
43. There are several interpretations of what the 'movements in market rates of interest' in paragraph B5.4.5 refers to, including:
  - (a) changes in an observable market-based variable such as a benchmark interest rate (as described in paragraph 42(a) of this paper);
  - (b) periodic changes in the market rate for a particular financial instrument that reflect entity-specific factors<sup>8</sup>; or
  - (c) adjustments to the contractual interest rate that are specified in the contract and reflect an expectation/approximation of what a market-based rate would be when the contingent event occurs.

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<sup>7</sup> The Implementation Guide of IFRS 9 example B24 also refers to a 'specified market-based variable rate'.

<sup>8</sup> This view appears to be based on the Agenda Decision of the January 2016 IFRS Interpretations Committee Meeting published in the January [2016 IFRIC update](#).

44. Depending on an entity’s interpretation of which changes paragraph B5.4.5 of IFRS 9 applies to, the effect on the financial statements could vary from something similar to fair value accounting on one end of the spectrum, to cash accounting on the other end.

*Floating-rate financial instruments*

45. The staff acknowledge that paragraph B5.4.5 of IFRS 9 does not define or elaborate on what is meant by floating rate. However, it is clear that a financial instrument with variable contractual cash flows – which are periodically adjusted to reflect movements in the market rates of interest – is a floating rate financial instrument.
46. We think a helpful point of reference might be paragraph B5.4.4 of IFRS 9 that clearly distinguishes between market-based variables which are periodically reset or repriced to reflect movement in the market rates of interest and other variables. For example, that paragraph refers to the ‘credit spread or other variables *over* the floating rate *specified* in the financial instrument which are not reset as they do not reflect the movements in the market rate of interest.
47. This view is also consistent with example B27 of the Guidance on implementing IFRS 9 where the contractual terms specify the rate for a period of time and that rate varies every period. Even though the contractual cash flows are ‘variable’ over the life of the instrument, ie cash flows are fixed for only for one period, the instrument is not considered a floating rate instrument because the contractual cash flows do not contain any parts that are reset to reflect the movements in the market rates of interest.
48. However, the staff acknowledge that range of interpretations have led to significant diversity in practice. This was also evident during the recent Interpretations Committee discussions on the TLTRO III transactions. We are therefore of the view that standard setting would be needed to provide clarity on the application of those requirements.

*Application of the measurement principle in paragraph B5.4.6*

49. In the absence of fees or other transactions costs, when applying the measurement principle in paragraph B5.4.6, revisions to the estimated timing of contractual cash flows usually does not result in any ‘catch up’ adjustments on the carrying amount of

a financial asset or financial liability.<sup>9</sup> However, revisions of the estimated amount of contractual cash flows usually result in an adjustment to the carrying amount (and resulting catch-up adjustment) recognised in profit or loss. Related to the questions about when and how to reflect conditionality in determining the EIR and to which changes in cash flows paragraph B5.4.5 is applied, are questions about which changes in expectations are subject to paragraph B5.4.6.

50. In the staff's view, paragraph B5.4.6 applies to any changes to the estimates of future contractual cash flows (excluding modifications in accordance with paragraph 5.4.3 of IFRS 9 and changes in estimates of expected credit losses), other than those changes to which paragraph B5.4.5 applies. However, we also note that if estimates of expected cash flows are frequently revised, adjusting the carrying amount of a financial instrument and recognising a 'catch up' in profit or loss might, over time lead to a deterioration of useful information to the users as previously discussed by the IASB.<sup>10</sup>
51. Given the interdependencies between the issues discussed in this paper, the staff is of the view that any standard setting project related to the effective interest method need to carefully consider the usefulness of the information provided to users of financial statements against the cost to preparers of applying paragraphs B5.4.5 and B5.4.6 of IFRS 9.

### ***Is standard setting required?***

52. Stakeholders have been raising questions and concerns about how to interpret and apply requirements of amortised cost measurement and the application of the effective interest method, in particular for floating rate instruments, well before the IASB started this PIR. This has invariably led to diversity in practice and some of the practices developed have become embedded in entities' systems and processes.
53. In the staff view, providing clarity, as has been requested by stakeholders for a long time, would most effectively be done through standard-setting.

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<sup>9</sup> This is under the assumption that the entity is compensated for the passage of time at the original EIR (for example the absolute amount of interest changes when repaying the principal one period later, however the present value will not).

<sup>10</sup> Refer to paragraph BC4.233 of IFRS 9.

54. The staff expect that issuing educational material or adding illustrative examples could supplement, but not replace, the need to clarify the scope and the requirements of the effective interest method.
55. In our view, if standard setting is undertaken in this area, the following areas for clarification could be considered:
- (a) the term ‘market rates of interest’ in paragraph B5.4.5 of IFRS 9 and what interest rates or market-based variables of the contractual interest rates it relates to;
  - (b) the term ‘floating rate’ in paragraph B5.4.5 of IFRS 9 and the interaction with the term ‘market rates of interest’;
  - (c) the treatment of conditionality attached to the contractual interest rate and how this conditionality affects the cash flow estimate for the purposes of calculating the effective interest rate; and
  - (d) the effect modifications have on determining the EIR.
56. We think it is important that all of these matters also consider potential interdependencies with other areas of IFRS 9, most notably the requirements for modifications of financial assets and financial liabilities and expected credit losses.
57. In our view, such clarification will help ensure that the relevant requirements are applied consistently and that the resulting measurement outcomes will faithfully represent the underlying economics and substance of the financial instruments.