IFRS® Accounting

Staff paper

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Project	**Amendments to the Classification and Measurement of Financial Instruments**
Topic	**Feedback analysis – Assessment of contractual cash flows - general**
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Purpose of this paper

1. In October 2023, the staff presented a paper to the IASB addressing feedback received on Question 2 of the Exposure Draft *Amendments to the Classification and Measurement of Financial Instruments* (ED) about assessing whether a financial asset has contractual cash flows that are solely payments of principal and interest (SPPI). This paper continues the analysis and asks for the IASB's approval of staff recommendations in response to the feedback received.

2. This paper is structured as follows:

   (a) summary of staff recommendations and question for the IASB;

   (b) recap of October 2023 IASB meeting; and

   (c) staff analysis and recommendations.

Summary of staff recommendations and question for the IASB

3. The staff recommend finalising the proposed amendments to paragraph B4.1.8A of the ED, subject to drafting improvements to clarify that although SPPI focuses on

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what an entity is compensated for rather than how much compensation the entity receives, the amount of compensation may be an indicator that the lender is being compensated for something other than basic lending risks or costs.

4. The staff also recommend amending the proposed amendments in paragraph B4.1.10A of the ED to require that, when the nature of the contingent event is not directly related to a change in basic lending risks or costs, a financial asset have contractual cash flows that are SPPI if:

    (a) irrespective of the probability of the contingent event occurring (except where the event is not genuine), the cash flows before and after any contingent event(s), when considered in isolation, are SPPI; and

    (b) the contractual cash flows arising from a contingent event is not significantly different from the cash flows on a similar financial asset without such a contingent event and do not represent an investment in the debtor or in particular assets or cash flows.

5. The staff further recommend updating the proposed examples in paragraph B4.1.13 and B4.1.14 of the ED based on the recommended refinements to the proposed amendments.

Question for the IASB
Does the IASB agree with the staff recommendations in paragraph 3–5?

Recap of October 2023 IASB meeting

6. Agenda Paper 16 for the October 2023 IASB meeting (the October paper) reported that almost all respondents agreed with, and were appreciative of, the IASB's intention to clarify the requirements for assessing whether the contractual cash flows of financial assets are SPPI, specifically in the case of financial assets with ESG-linked features.

7. However, the main concerns with the proposed amendments expressed by respondents related to:

   (a) how the proposed clarifications to the concept of a basic lending arrangement apply in the case of ESG-linked features (see paragraphs 11–13 of the October paper);

   (b) when and how to consider the size of changes in contractual cash flows (see paragraphs 14–17 of the October paper);

   (c) the scope and application of the proposals in paragrpaph B4.1.10A of the ED, in particular the requirement for a contingent event to be specific to the debtor (see paragraphs 18–21 of the October paper); and

   (d) the intention with the reference to 'neither an investment in the debtor nor an exposure to the performance of specified assets' (see paragraph 22 of the October paper).

8. In considering how to respond to the feedback, the staff looked to build on existing application guidance in IFRS 9 which permit an entity to conclude that, if specified criteria are met, the cash flows over the life of a financial asset are SPPI even though the financial asset contains a contractual feature that might not appear to be consistent with a change in basic lending risks or costs.

9. The staff suggested removing the reference to the 'magnitude' of the change in cash flows and the criterion to assess whether the contingent event is specific to the debtor. Instead, we suggested specifying criteria to consider if the nature of the continent event does not appear to be consistent with a basic lending arrangement, such as that the fair value of the contractual feature, that led to the change in cash flows, at initial recognition is insignificant.

10. The staff also suggested replacing the terms 'investment in the debtor' and 'performance of specified assets' with the term 'investment in particular assets or cash flows' to align with the wording in paragraph B4.1.16 of IFRS 9.

11. IASB members generally supported the staff's analysis and the suggested refinements. However, some IASB members questioned how the proposed refinements are intended to interact with other requirements in IFRS 9 and wanted to ensure that the general principles of the SPPI assessment are maintained. Some IASB members also had concerns about requiring an entity to assess whether the fair value of the contractual term is insignificant at initial recognition, including whether such an assessment would:

    (a) be practical for entities to perform and document;

    (b) be made in aggregate, or separately for each possible change to the contractual cash flows;

    (c) take into account the probability of the contingent event occurring; and

    (d) risk resulting in divergent conclusions on the same fact pattern.

Staff analysis and recommendations

12. In developing recommendations for the refinement of the proposed clarifications in the ED, the staff have considered the questions and comments from IASB members and a small group of stakeholders we reached out to, in response to the October paper. This section sets out the staff's updated analysis on:

    (a) the amount of compensation an entity receives;

    (b) the interaction between different SPPI requirements;

    (c) potential challenges associated with the significance of the fair value of a contractual term at initial recognition;

    (d) an alternative way of considering the significance of a contractual term; and

    (e) examples to illustrate the clarified requirements.

The amount of compensation an entity receives

13. As discussed in paragraph 38 of the October 2023 paper, the staff agreed with respondents to the ED that it is not helpful to imply that the 'magnitude' of changes in contractual cash flows needs to be considered without being more specific about what such a consideration would require.

14. Nevertheless, the staff believe that it would be helpful to refine the proposals in paragraph B4.1.8A of the ED by clarifying that the amount of compensation that an entity receives may be an indication that the entity is being compensated for something other than basic lending risks or costs. Such a clarification would help explain why, even though the SPPI assessment focuses on what a lender is being compensated for rather than how much compensation the entity receives, in some cases an entity may need to consider the amount of compensation if it is not clear what the entity is being compensated for (see paragraphs 31-32 below).

The interaction between different SPPI requirements

15. As illustrated through the questions on whether financial instruments with ESG-linked features have SPPI cash flows, there are financial assets that would otherwise have contractual cash flows that are SPPI but that do not appear to meet that condition only as a result of the nature of the contingent event not being directly related to basic lending risks or costs.

16. When developing the proposed clarifications in the ED, the IASB established robust principles to support the current requirements in IFRS 9 to assist entities in assessing the cash flows. This includes the requirement that:

    (a) the cash flows before and after the contingent event(s) are SPPI. In other words, the cash flows that would arise if the contingent event(s) occurred (or did not occur) can be determined or is known (paragraph B4.1.10 of IFRS 9);

(b) the cash flows are assessed assuming that the contingent event occurs and the probability of the event occurring is not considered (except where the event is not genuine) (paragraph B4.10A of the ED); and

(c) the resulting cash flows do not represent an investment in the entity or in particular assets or cash flows (paragraphs B4.1.16 of IFRS 9 and B4.10A of the ED).

17. Paragraph B4.1.10 of IFRS 9 states:

> While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk.

18. This paragraph implies that it is 'more likely' that the cash flows on a financial asset will be SPPI over the life of the instrument if the change in contractual cash flows is aligned with a change in the credit risk of that instrument. In the context of paragraph B4.1.7A of IFRS 9, one can infer that the same principle applies for changes in other basic lending risks and costs.

19. On the other hand, if the nature of the contingent event that results in a change in contractual cash flows is not directly related to basic lending risks and cost (as in the example of a specified equity index reaching a specific level), paragraph B4.1.10 of IFRS 9 implies it is 'less likely' that the cash flows on the instrument is SPPI. If cash flows change in response to an underlying variable such as an equity index, it is clear from applying paragraph B4.1.7A of IFRS 9 that this introduces exposure to risks or changes in cash flows that are unrelated to a basic lending arrangement.

20. As discussed in paragraph 43 of the October paper, the proposals in paragraph B4.1.10A of the ED were not intended to disrupt market practice that has developed in applying paragraph B4.1.10 of IFRS 9 and the other requirements in IFRS 9.

21. While it is clear from paragraphs B4.1.7A–B4.1.19 of IFRS 9 that contractual cash flows that change as and when ('tracks') for example an underlying variable such as an equity or commodity index or the entity's revenue change, are not SPPI, uncertainty still remains about whether, or when, the nature of the contingent event affects the SPPI assessment, especially in the context of applying paragraph B4.1.10 of IFRS 9 as noted in paragraph BC54 of the Basis for Conclusions on the ED.

Significance of the fair value of the contractual term at initial recognition

22. In an attempt to answer the question in paragraph 21 of this paper, the staff considered in the October 2023 paper a clarification similar to the existing requirement in paragraph B4.1.12 of IFRS 9 to assess whether the fair value of the contractual feature that gives rise to the change in the contractual cash flows, is insignificant at initial recognition.

23. However, on further reflection the staff acknowledge that the requirements in paragraph B4.1.12 of IFRS 9 are described in paragraph BC4.192–B4.195 of the Basis for Conclusions on IFRS 9 as 'a narrow exception' applicable in the specific scenario in which a financial asset that is acquired or issued at a premium or discount is prepayable at the par amount. The IASB further observed that although many purchased credit-impaired financial assets and some financial assets originated at below-market interest rates are purchased at a deep discount (and therefore would not have SPPI cash flows if they were prepaid immediately at the par amount), the prepayment feature would have an insignificant fair value if it is very unlikely that prepayment will occur. Therefore, the fair value of the prepayment feature is used here as one of the indicators that amortised cost would provide relevant and useful information to users of financial statements.

24. In contrast, there are several reasons why the fair value of other contractual features that could change the amount or timing of contractual cash flows, may be insignificant at initial recognition, including:

    (a) the adjustments to the cash flows (irrespective of the probability of the contingent event occurring) are small relative to the total cash flows on the financial asset;

    (b) the probability of the contingent event causing a change in cash flows is low (even if the adjustment isn't small); and

    (c) the contractual feature includes possible offsetting adjustments which result in a net fair value that is insignificant on initial recognition (even if the individual adjustments are not small).

25. The scenario described in subparagraph 24(a) of this paper is consistent with the rationale for considering the fair value of the contractual feature discussed in paragraphs 41-42 of the October paper. According to feedback on the PIR and the ED, as well as academic studies, typically adjustments to cash flows relating to ESG-linked factors are relatively small in comparison to the overall cash flows of the financial asset and are not set based on a detailed assessment of the underlying ESG-linked factors.[1] Therefore, measuring such financial assets at fair value through profit or loss would not provide useful information to users of financial statements as the fair value movements on these instruments would be dominated by changes in interest rates and credit risk, rather than changes in the relevant ESG factors.[2]

26. However, if the fair value of a contractual feature is insignificant on initial recognition because the probability of an event occurring is low (see paragraph 24(b) of this paper), this would not necessarily be a good indicator that the overall cash flows on the financial asset are SPPI over the life of the instrument. The effect on

[1] For example, this study found that pricing provisions usually include immaterial performance indicators and weak targets, which are not related to a borrower's ESG risk. The study further found that for loans studied, the average absolute value of LIBOR-spread adjustments based on sustainability performance targets was 4.8 basis points, compared to an average LIBOR spread of 161.9 basis points.

[2] This is consistent with the feedback received on the PIR as summarised in paragraph 16 of Agenda Paper 3B for the April 2022 IASB meeting

the cash flows over the life of the instrument if the contingent event occurs could be significant, however this might not be considered in the SPPI assessment if the focus is only on initial recognition. Furthermore, in paragraph BC4.189 of the Basis of Conclusions on IFRS 9, the IASB responded to feedback received in the process of the developing the SPPI requirements by confirming the guidance in IFRS 9 that an entity is not permitted to take into account the probability that the future event will occur, unless the contingent feature is not genuine. Therefore, such scenarios would not be consistent with the objective of the SPPI assessment.

27. The scenario described in 24(c) of this paper raises a question as to whether the fair value of contractual features should be considered on an overall basis, or separately for potentially offsetting adjustments. The staff therefore believe that a criterion to consider the fair value of the contractual feature at initial recognition would need to be accompanied by further explanations on how to apply such a criterion to avoid diversity in practice and to ensure that amortised cost measurement is applied to the appropriate instruments.

28. Of the three scenarios described in paragraph 24 of this paper, the staff are of the view that only scenario 24(a) would not be inconsistent with a basic lending arrangement and give rise to a financial asset with contractual cash flows that are SPPI. Given the potential challenges with using the fair value of a particular feature as a requirement, we think it would be more consistent with the current SPPI requirements to develop further application guidance based on overall effect on the contractual cash flows compared to a similar instrument without such a contractual feature. In our view, such an approach would provide information not only about the fair value of the contractual feature at initial recognition, but also about the possible effects on the cash flows throughout the life of the financial asset.

An alternative way of considering the significance of a contractual term

29. As stated in paragraphs 18–19 of this paper, it seems clear that when a change in contractual cash flows arise from a change in basic lending risks and/or costs (as

described in paragraph B4.1.7A of IFRS 9), the effect on the overall cash flows is still SPPI. It is also clear that, even if the cash flows before the contingent event are SPPI, if the cash flows after the contingent event are not SPPI, the financial asset do not have cash flows that are SPPI for the purposes of IFRS 9.

30. Where questions arise are where the cash flows both before and after the contingent event(s) are SPPI when considered in isolation, but the nature of the event is not consistent with a basic lending arrangement. More specifically, stakeholders note that paragraph B4.1.10 of IFRS 9 states that the nature of the contingent event may not in itself be a determinative factor, it may be an indicator that the cash flows on the financial asset is not SPPI.

31. Instead of using the fair value of the contingent feature to assess whether the cash flows arising from the contingent event, the staff think it would be more consistent with the current SPPI requirements if (subject to all the other requirements in paragraph 16 of this paper) the overall cash flows on the financial asset with such a contingent feature is compared to the overall cash flows on a similar financial asset without such a contingent feature.

32. The purpose of this comparison is to determine how different the contractual cash flows would be from the cash flows that would arise if the contingent event did not exist. This is broadly consistent with the comparison for a financial asset with a modified time value of money component (see paragraphs B4.1.9AB–B.4.1.9D of IFRS 9). If the contingent event could result in cash flows that are significantly different from the cash flows on a similar financial asset without such a contingent event, the financial asset does not have cash flows that are SPPI. Therefore, if the cash flows arising from the contingent event are not significantly different from those on a similar instrument without such a contingent event, the nature of the contingent event does not affect the SPPI assessment.

33. Similar to the modified time value assessment, the staff note that if it is clear from little or no analysis that the contractual cash flows under assessment could (or could not) be significantly different from the cash flows on a similar financial instrument

without the contractual term, an entity does not need to perform a detailed assessment. However, unlike the requirement for the modified time value of money in paragraph B4.1.9D of IFRS 9, where the entity must consider only reasonably possible scenarios, for the purposes of paragraph B4.1.10 of IFRS 9, the entity would need to consider all scenarios in which the contractual cash flows are changed in response to a contingent event, regardless of the probability of the event (ie assume that every contingent event occurs).

34. The staff believe that in practice entities (taking into account the specific characteristics of the economic environment such as the level of interest rates) would be able to determine a range of adjustments to contractual cash flows which would result in cash flows that are not significantly different from the cash flows of similar financial assets without such contractual features. The staff therefore do not believe that such a requirement would necessarily require a detailed assessment on an individual basis.

35. We have considered whether, for the purposes of the assessment described in paragraphs 31 and 32 of this paper, the requirement be based on that the cash flows are not significantly, or not 'more than insignificantly', different from those on a similar financial asset without the contingent feature. We considered the feedback the IASB received on the modified time value of money element that 'more than insignificant' can be unduly restrictive as discussed in paragraph BC4.177(c) of the Basis for Conclusions on IFRS 9. We also considered that the SPPI assessment is not a mathematical or scientific analysis whether the compensation an entity receives is accurate, reasonable or 'priced correctly'—there are other requirements in IFRS 9 that account for when that is not the case. The SPPI assessment is focusing on what an entity is being compensated for, rather than how much compensation it receives (also see paragraph 14 of this paper).

36. We therefore considered that a threshold of 'not more than insignificantly' would again unduly emphasise the 'how much' and give risk to more questions about what would be the tipping point. We also think that entities would be able to develop

their own internal policies on what constitutes ‘significantly different’ in this context. The application guide to IFRS 9 contain various examples of quantitative concepts without defining specific quantitative thresholds, including:

(a) as part of the business model assessment, paragraph B4.1.3B of IFRS 9 requires an entity to consider whether sales are ‘insignificant in value both individually and in aggregate’;

(b) for financial assets with a modified time value of money, paragraph B4.1.9C of IFRS 9 requires an entity to assess whether the modified time value of money element could result in contractual (undiscounted) cash flows that are ‘significantly different’ from the (undiscounted) benchmark cash flows; and

(c) paragraph B4.1.11(b) of IFRS 9 states that a contractual term that permits prepayment results in contractual cash flows that are SPPI of the prepayment amount ‘substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for the early termination of the contract’.

37. In the PIR feedback, most respondents said that these requirements work well in practice and entities are able to set their own internal thresholds based on these requirements. This suggests that entities will be able to find a practical way to apply the refined requirements.

38. However, to avoid any unintended consequences whereby the entities might look to instruments that do not have SPPI cash flows and still conclude that those cash flows are not significantly different from those on an instrument with SPPI cash flows and therefore qualify to be measured at amortised cost, the staff think it is important to emphasise that the refined amendments would only apply in cases where the nature of the contingent event is not directly related to a change in basic lending risks or costs and:

(a) the cash flows before and after any contingent event(s) when considered in isolation, are SPPI;

(b) the cash flows are assessed assuming that the contingent event occurs and the probability of the event occurring is not considered (except where the event is not genuine);

(c) the resulting cash flows do not represent an investment in the entity or in particular assets or cash flows (paragraphs B4.1.16 of IFRS 9 and B4.1.10A of the ED); and

(d) the contractual cash flows arising from a contingent event is not significantly different from the cash flows on a similar financial asset without such a contingent event.

39. The staff think it is also useful to note the difference between such a requirement and the existing provisions in paragraph B4.1.18 of IFRS 9 whereby 'a contractual cash flow characteristic does not affect the classification of a financial asset if it could have only a de minis impact on the cash flows.' Firstly, the de minimis principle applies to all contractual features, whereas the recommended requirements would only apply in specific cases where the cash flows before and after an event is SPPI when viewed in isolation, but the nature of the event is not directly linked to changes in basic lending risks and costs. Secondly, a contractual feature could have more than a de minimis impact on contractual cash flows but the cash flows over the life of the financial asset could still not be significantly different from the cash flows on a similar financial asset without this contractual feature.

Examples to illustrate the clarified requirements

40. Almost all respondents welcomed the proposed addition of examples to illustrate the application of the clarified requirements in IFRS 9 to instruments with ESG-liked features. Some respondents added that the proposed examples were clear and helpful. However, many respondents asked for the analysis of the proposed examples to be expanded or clarified.

41. Some respondents asked for additional examples to be added to cover a wider range of contractual features or to illustrate the application of the clarified requirements in

more complex scenarios, including changes in contractual cash flows linked to the achievement of social and governance targets (as opposed to, or in addition to, environmental targets).

42. The staff acknowledge that the analyses of the proposed examples the ED should be updated to illustrate the application of the updated requirements.

43. The staff do not recommend any changes to the fact pattern for instrument EA in paragraph B4.1.13 of the ED as feedback indicated that it is a representative, if simplified, example of a common type of ESG-linked contractual feature. The staff recommend updating the analysis of the instrument based on the recommended refinements in paragraph 38 of this paper.

44. The staff recommend updating the fact pattern for Instrument I to provide a clearer example of a contractual feature that does not result in contractual cash flows that are not SPPI and which would not require further analysis according to the criteria recommended in paragraph 38 of this paper.

45. With regards to the regard to the requests for additional examples, the staff do not believe that additional examples would be useful, because the refinements proposed to the clarifications in IFRS 9 do not focus on the nature of the contingent event. Therefore, the staff do not believe that an example of adjustments linked to social factors such as the demographic composition of a company's board, or to a combination of environmental and social factors, would give entities additional insight into applying the clarified requirements.