

Assessing Whether to Separate an Embedded Prepayment Option from Host Contract (IFRS 9 *Financial Instruments*)

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Paragraph B4.3.5(e) of IFRS 9 *Financial Instruments* applies to a situation where debt that has been issued by the reporting entity, the borrower, has an early repayment option within the contract. In particular, paragraph B4.3.5(e) states that the prepayment option that is embedded in the host debt contract is not closely related to the host contract, with two exceptions. One of those exceptions, (ii) in paragraph B4.3.5(e), is where *"the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract"*.

Paragraph B4.3.5(e) then goes on to define lost interest as *"the product of the principal amount prepaid multiplied by the interest rate differential"*. The standard then defines the interest rate differential as *"the excess of the effective interest rate of the of the host contract over the effective interest rate **the entity** would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract"* (bold highlighting added).

There are differing interpretations in practice as to whether *"the entity"* (see bold highlighting) should be interpreted to mean 'the lender' or 'the reporting entity' (i.e. the borrower). This is an important consideration because the borrower is not in the lending business, so would therefore assume a reinvestment interest rate that is standard return such as a treasury gilt yield, whereas the lender is in the lending business and thus would be expected to command a higher reinvestment interest rate. The distinction between *"the entity"* meaning 'the lender' or 'the reporting entity' can be significant, as it can be the difference between (a) the exercise price of the prepayment option reimbursing the lender for an amount up to the present value of the lost interest, or (b) not doing so. It can therefore determine whether an embedded derivative is separately recognised or not.

One interpretation is that *"the entity"* is intended to refer to 'the lender' as lost interest should be considered from the lender's perspective. It is observed that to consider lost interest from the perspective of the borrower would not represent the substance of the transaction or reflect the economic reality of what you would legally have to pay the lender if you did prepay.

Another interpretation is that the wording in the standard is clear, so *"the entity"* is 'the reporting entity' and lost interest should be considered from the reporting entity's perspective. It is observed that to consider lost interest from the lender's perspective would mean that:

- (a) there is automatically no embedded derivative as the *"interest rate"* variable in the context of paragraph 4.3.1 of IFRS 9 (which defines an embedded derivative) would then be the lender reinvestment interest rate which does not impact the cash flows of the reporting entity and thus cannot be an asset or indeed an embedded derivative on the balance sheet of the reporting entity;
- (b) there is an inconsistency between the two elements of the calculation of the interest rate differential, as the effective interest rate is calculated from the reporting entity's perspective; and
- (c) the lost interest test becomes irrelevant as the interest rate differential will always be zero given that the assessment is performed at the outset of the contract, such that the lender's reinvestment interest rate is in practice assumed to be the effective interest rate of the host contract.

This issue is considered likely to be widespread in practice for the following reasons:

- (1) Prepayment options are commonplace in practice, and there is nothing unusual about this particular prepayment option by reference to prior periods or other reporting entities, and yet an embedded derivative was not separately recognised by the reporting entity in prior period audited financial statements and is not separately recognised by many competitors or other borrowers;
- (2) The accounting interpretations issued by the Big 4 audit firms do not resolve the issue, but the national technical department of one such audit firm took the view that “*the entity*” is intended to refer to ‘the lender’, contrary to how the term ‘the entity’ is used elsewhere in IFRS (i.e. to refer to the ‘reporting entity’);
- (3) Paragraph B4.3.5(e) of IFRS 9 is internally inconsistent. If “*the entity*” is intended to mean ‘the lender’, this does not reconcile with paragraph 4.3.1 of IFRS 9 (see above) and why use the alternative phrase “*the lender*” elsewhere in the same paragraph B4.3.5(e)? If “*the entity*” is intended to mean ‘the reporting entity’, why state “*if it reinvested*” as borrowers do not generally reinvest (i.e. they might, rather, borrow from an alternative lender)?

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