IFRS Accounting

Staff paper

Agenda reference: 3

IFRS® Interpretations Committee meeting

Date	**June 2025**
Project	**Embedded prepayment option (IFRS 9)**
Topic	**Initial consideration**
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the application of the requirements in paragraph B4.3.5 of IFRS 9 *Financial Instruments* to determine whether to separate an embedded prepayment option in a loan agreement.

2. The objective of this paper is:

   (a) to provide the Committee with a summary of the matter;

   (b) to present our research and analysis; and

   (c) to ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure

3. This paper includes:

   (a) background and summary of the submission (paragraphs 5–9);

   (b) findings from information request (paragraphs 10–14);

(c) staff analysis (paragraphs 15–17); and

(d) staff recommendation (paragraphs 18–19).

4. There are two appendices to this paper:

(a) Appendix A—suggested wording for the tentative agenda decision; and

(b) Appendix B—submission.

Background and summary of the submission

5. The submission (reproduced in Appendix B) asks whether, for purposes of applying paragraph B4.3.5(e)(ii) of IFRS 9 to a prepayment option in a financial liability, the reference to 'the entity' should be read to refer to 'the lender' or 'the reporting entity' (that is the borrower).

6. Paragraph B4.3.5(e)(ii) of IFRS 9 states:

> …
>
> e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
>
> …
>
> (ii) 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. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate 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 [emphasis added].

7. The submission states that there are different views in practice with regards to the meaning of 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9:

(a) one interpretation is that 'the entity' refers to 'the lender' because 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 a borrower would legally have to pay the lender if it did prepay.

(b) another interpretation is that, similar to references to entity in other IFRS Accounting Standards, 'the entity' is 'the reporting entity' (that is the borrower) and lost interest should be considered from the reporting entity's perspective.

8. The distinction between 'the entity' meaning 'the lender' or 'the borrower' can be significant, because the assessment of whether or not to separate an embedded derivative from the host contract, could be different depending on whether it is assessed from the lender's or the borrower's perspective. The effects of accounting for an embedded derivative at fair value through profit or loss and for a host contract at amortised cost could materially differ from the effects of accounting for the entire financial liability at amortised cost.

9. The submission—reproduced in Appendix B—includes further information about the alternative views identified by the submitter. We also made the submission available on our website.

Findings from information request

10. We sent an information request to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms. The request asked whether the respondents are aware of divergent interpretations, similar to those described in the submission (see paragraph 7), being applied in their jurisdictions; and, if so, whether such diversity is widespread and could have a material effect on those affected.

11. We received 15 responses—seven from national accounting standard-setters, seven from accounting firms and one from a member of the Committee representing a

preparer. The responses represent informal opinions and do not necessarily reflect the official views of those respondents or their organisations.

Interpretation of the term 'the entity'

12. All respondents said they did not observe diversity with regards to the interpretation of the term 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9. They said that entities read this word as referring to the lender, because:

    (a) the first sentence of paragraph B4.3.5(e)(ii) of IFRS 9 states that '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 [emphasis added]'. The last sentence of that paragraph that refers to 'the entity' simply specifies how to apply the principle outlined in the first sentence;

    (b) only 'the lender' makes sense in the context of lost interest and the reinvesting the prepaid amount;

    (c) paragraph BCZ4.97 of the Basis for Conclusions on IFRS 9 refers to 'compensation to the lender' when explaining the IASB's intention in providing the exception to embedded prepayment option not being closely related to the host contract in paragraph B4.3.5(e)[1];

    (d) guidance on embedded derivatives issued by some of the large accounting firms makes it clear that 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9 means 'the lender'.

[1] Paragraph BCZ4.97 of IFRS 9: '...This exception is in respect of prepayment options, the exercise prices of which compensate *the lender* for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating *the lender* for loss of interest by reducing the economic loss from reinvestment risk. [emphasis added]'

13. A few respondents suggested the IASB consider replacing 'the entity' with 'the lender' in paragraph B4.3.5(e)(ii) of IFRS 9 for clarity—this could be done, for example, as part of the Annual Improvements process[2].

14. One accounting firm said that, in many instances, the fair value of the prepayment option is not material as the terms of the option typically are set to disincentivise a borrower from prepayment.

Staff analysis

Should the Committee add this matter to its standard-setting agenda?

Does the matter have widespread effect and have, or is expected to have, a material effect on those affected?[3]

15. Although the submission discusses two potential interpretations of the reference to 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9, findings from our information request indicate that all respondents read the requirements as referring to the lender for the reasons described in paragraph 12. As the responses to our information request did not provide evidence of widespread diversity in practice, we have not obtained evidence that the matter has widespread effect—in other words, diversity in application that could have a material effect on entities' financial statements.

16. Consequently, we recommend that the Committee not add a standard-setting project to the work plan and instead publish a tentative agenda decision that explains its reasons for not adding a standard-setting project.

17. Our recommendation is based on evidence we obtained to date from our information request. Should there be additional evidence which could lead to a different conclusion on whether the matter has widespread effect, stakeholders will have the

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[2] Paragraphs 6.10–6.15 of the *Due Process Handbook*.

[3] Paragraph 5.16(a) of the *Due Process Handbook.*

opportunity to share this with the Committee by providing feedback to the tentative agenda decision.

Staff recommendation

18. Based on our assessment of the criteria in paragraph 5.16 of the *Due Process Handbook* (as discussed in paragraphs 15–17), we recommend not adding a standard-setting project to the work plan and instead publishing a tentative agenda decision that explains the Committee's reasons for not adding a standard-setting project.

19. Appendix A to this paper suggests wording for the tentative agenda decision.

Questions for the Committee

1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
2. Does the Committee have any comments on the wording of the tentative agenda decision suggested in Appendix A to this paper?

Appendix A—suggested wording for the tentative agenda decision

Embedded prepayment option (IFRS 9 *Financial Instruments*)

The Committee received a request about the application of the requirements in paragraph B4.3.5 of IFRS 9 *Financial Instruments* to determine whether to separate an embedded prepayment option in a loan agreement.

Fact pattern

The submission asked whether, for purposes of applying paragraph B4.3.5(e)(ii) of IFRS 9 to a prepayment option in a financial liability, the reference to 'the entity' should be read to refer to 'the lender' or 'the reporting entity' (that is the borrower).

In the fact pattern described in the submission a reporting entity (the borrower) signed a loan agreement that contains an early repayment option (the prepayment option). The submission states that there are different views in practice with regards to the meaning of 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9:

(a) one interpretation is that 'the entity' refers to 'the lender' because 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 a borrower would legally have to pay the lender if it did prepay.

(b) another interpretation is that, similar to references to entity in other IFRS Accounting Standards, 'the entity' is 'the reporting entity' (that is the borrower) and lost interest should be considered from the reporting entity's perspective.

The distinction between 'the entity' meaning 'the lender' or 'the reporting entity' can be significant, because the assessment of whether or not to separate an embedded derivative from the host contract, could be different depending on whether it is assessed from the lender's or the borrower's perspective. The effects of accounting for an embedded derivative at fair value through profit or loss and for a host contract at amortised cost could materially differ from the effects of accounting for the entire financial liability at amortised cost.

Findings and conclusion

Evidence gathered by the Committee [to date] indicates no diversity that could have a material effect on entities' financial statements with regards to interpretating the term 'the entity' in paragraph B4.3.5(e)(ii) of IFRS 9. Feedback suggests that entities read the requirements as referring to the lender.

Based on its findings, the Committee concluded that the matter described in the request does not have widespread effect. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of the request.

Potential Agenda Item:

Subject

B2. Interpretation of IFRS 9 *Financial Instruments* to assess whether to separate an embedded prepayment option from a host contract.

Background information and opposing opinions

B3. Paragraph B4.3.5(e) of IFRS 9 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"*.

B4. 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 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).

B5. 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.

B6. 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.

B7. 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.

B8. This issue is considered likely to be widespread in practice for the following reasons:

(a) 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;

(b) 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’);

(c) 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)?