IFRS Accounting

Staff paper

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IASB® meeting

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Project	**Amortised Cost Measurement**
Topic	**Determining Effective Interest Rate at initial recognition**
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Purpose and structure of the paper

1. At this meeting, the IASB begins deliberations of issues in scope of the Amortised Cost Measurement project.

2. This paper provides the staff analysis and recommendation on whether the IASB should clarify requirements for determining the effective interest rate (EIR) for financial instruments with conditions attached to the contractual interest rate.

3. This paper is structured as follows:

   (a) summary of staff recommendation;

   (b) question for the IASB;

   (c) background;

   (d) a reminder of the 2025 outreach feedback; and

   (e) staff analysis.

4. This paper includes Appendix A—Review of accounting firms' manuals.

Summary of staff recommendation

5. We recommend the IASB take no further action regarding the application issues that arise in determining the EIR at initial recognition for financial instruments with conditions attached to the contractual interest rate.

6. The staff analysis suggests that although there are differences in how entities apply these requirements, standard-setting might not effectively resolve these differences. That is because:

   (a) the differences regarding whether and which conditional terms entities consider in the EIR calculation are not attributable to unclear requirements. The definition of EIR in Appendix A of IFRS 9 *Financial Instruments* is clear, **all** contractual terms and conditions shall be considered, except in **rare cases** when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument; in such cases, contractual cash flows are used. Outreach findings indicate that entities not considering conditional terms in the EIR calculation often do so due to materiality assessments or insufficient information available for a reliable estimate.

   (b) although IFRS 9 does not prescribe methods for considering conditional terms in the EIR calculation, outreach findings indicate that entities use judgment to select appropriate methods based on relevant facts and circumstances, often applying other IFRS Accounting Standards by analogy. As a result, clarifications in this area may not lead to substantial improvements in financial reporting.

Question for the IASB

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 5?

Background

IFRS 9 requirements

Appendix A to IFRS 9 defines the EIR of a financial instrument as:

(emphasis added)

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 <u>all</u> the contractual terms** of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses … 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).

Feedback on the post-implementation reviews (PIRs) of IFRS 9

In response to the Post-implementation Review of IFRS 9—Classification and Measurement, many stakeholders requested clarifications on how to calculate EIR for financial instruments with conditions attached to the contractual interest rate.

Most questions in this area were related to 'behavioural' terms and conditions affecting the amount of contractual interest to be paid—for example, an adjustment in the contractual interest rate based on the borrower's performance or sustainability-linked targets.

Specifically, stakeholders asked for clarification on:

- **whether** conditional contractual terms, such as specified adjustments to the contractual interest rate, shall be considered in that estimate of future cash payments or receipts. Stakeholders said that it is sometimes difficult to determine a reliable estimate of future cash flows for financial instruments with conditions attached to the interest rate; and
- **how** such conditional terms shall be considered in the estimated cash flows through the expected life of the financial instrument. Stakeholders said that IFRS 9 is not clear on what method to use—for example, whether the entity is required to use a probability-weighted average (or expected value) or the most likely outcome when estimating future cash flows.

Feedback from previous projects

TLTRO III transactions

The IFRS Interpretations Committee (Committee) received a request about how to account for the third programme of the targeted longer-term refinancing operations (TLTROs) of the European Central Bank (ECB). The TLTROs link the amount a participating bank can borrow and the interest rate the bank pays on each tranche of the operation to the volume and amount of loans it makes to non-financial corporations and households.

Among other questions, the Committee was asked how the bank calculates the applicable EIR.

The Committee concluded that the matters described in the request are part of a broader matter that, in isolation, were not possible to address in a cost-effective manner and were reported to the IASB.

2009 Exposure Draft

In November 2009, the IASB published the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (2009 Exposure Draft) as part of replacing IAS 39 *Financial Instruments: Recognition and Measurement*.

In the 2009 Exposure Draft, the IASB proposed to explicitly state the objective of amortised cost is—'to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument.'

The 2009 Exposure Draft further expanded on that objective by clarifying:

- that amortised cost is a measurement that combines current cash flow information at each measurement date with a **valuation** of those cash flows **that reflects conditions** on initial recognition of the financial instrument; and
- the types of amounts that are allocated over the expected life of the financial instrument (including for a financial asset the initial estimate of expected credit losses).

The 2009 Exposure Draft proposed to underpin the objective of amortised cost measurement with measurement principles, including the principle that the estimates of the cash flows are **expected values** at each measurement date. Hence, estimates of amounts and timing of cash flows would be the **probability-weighted** possible outcomes.

Overall, this exposure draft proposed an approach whereby the recognition of interest revenue and the recognition of expected credit losses were coupled together through the calculation of the EIR (coupled approach).

This coupled approach represented a significant change in practice and therefore most feedback on the 2009 Exposure Draft focused on proposals related to estimating expected credit losses rather than on other proposed principles relating amortised cost measurement.

Nonetheless, many respondents to the 2009 Exposure Draft explicitly expressed concerns about prescribing the probability-weighted possible outcomes method. They suggested that a 'best estimate' or 'most likely' outcome approach might be better in some situations (eg for a single instrument instead of a portfolio of homogenous loans).

Consequently, the IASB did not finalise its proposals about amortised cost principles, and the approach to determining the EIR for financial instruments.

A reminder of the 2025 outreach feedback

7. During H1 2025, the IASB met with stakeholders from various industries and regions (2025 outreach) to gather information about the root causes of potential diversity in application of the amortised cost measurement requirements.

8. Paragraphs 9–10 of this paper provide a reminder of the key messages from the 2025 outreach relating application of IFRS 9 requirements for determining the EIR. [1]

Which conditional terms to consider in EIR calculation

9. The 2025 outreach feedback suggested that:

   (a) it is clear to stakeholders from the definition of the EIR, as set out in Appendix A of IFRS 9, that an entity is required to consider all the contractual terms and conditions of an instrument in estimating the expected cash flows for purpose of calculating EIR at initial recognition of a financial instrument, ie including any conditional terms that might change the contractual interest rate.

   (b) in practice, however, many entities consider **some**, but **not all**, conditional terms in calculating EIR at initial recognition. For example, an entity would

[1] Agenda Paper 11A of the June 2025 IASB meeting provides detailed feedback from the 2025 outreach.

reflect its expectations for prepayment options being exercised into the estimated future cash flows but would not reflect its expectations about other conditional terms such as ESG-linked targets being met. Instead, they would recognise the changes in cash flows from those terms only if and when the contingent event occurs. These practices were justified either based on materiality judgements or because of insufficient information available to support a reliable estimate. For example, lack of adequate historical data to assess the likelihood of a contingent event occurring.

How to consider conditional terms in EIR calculation

10. The outreach participants representing entities that reflect conditional terms in the EIR calculation said that they use either of the following methods, depending on facts and circumstances:

   (a) **the most likely outcome**—the single most likely outcome in a range of possible outcomes. This is the most common method used among both financial and non-financial institutions. For instance, representatives of non-financial institutions noted that this is the only method they use in calculating the EIR for financial liabilities. In their view, the method is practical because it is a binary estimate of whether management expects the contingent event to occur or not, rather than considering a range of possible outcomes. However, they noted that this method requires estimation on an individual financial instrument basis (ie it is less suitable for a collective estimate).

   (b) **the probability-weighted possible outcomes (expected value)**—based on a range of possible outcomes. This method is applied in some cases, primarily in context of collective estimates when there is a range of possible outcomes that are neither binary nor concentrated on one outcome. Some banks said that they use a probability-weighted method in estimating the expected cash flows for a homogenous portfolio of financial assets (for example, retail loan portfolios) in estimating the probability that the prepayment option will be exercised.

Staff analysis

11. As discussed in February 2025, information collected in the 2025 outreach about the root causes of diversity in practice will ultimately assist the IASB in assessing whether it can resolve an issue effectively and efficiently.

12. Specifically, such information would help the IASB distinguish between issues for which differences in accounting arise because:

    (a) IFRS 9 is silent or has no explicit requirements or application guidance. The IASB can resolve these issues by clarifying the underlying principles, including adding requirements and application guidance to achieve more consistent application.

    (b) IFRS 9 requires application of judgement to determine accounting outcomes. Standard-setting cannot resolve these issues effectively because different outcomes result from different facts and circumstances, such as local laws or regulations or management's expectations about future cash flows.

    (c) the IFRS 9 requirements are viewed as impractical or operationally complex, resulting in entities developing 'simplified' accounting policies that, for example, align with their system capabilities. For these issues, the IASB would need to carefully evaluate whether the costs of applying the requirements for preparers exceed the benefits of the resulting information for the users of financial statements. Simplified approaches might be considered if they achieve an appropriate balance between costs and benefits.

Which conditional terms to consider in EIR calculation

13. As noted in paragraph 9, the differences in accounting outcomes that arise from entities' decisions on whether and which conditional terms they consider in the EIR calculation is not caused by IFRS 9, but it is caused by the judgements that entities make based on facts and circumstances or because entities conclude that it is not

possible to reliably estimate the expected future cash flows due to insufficient information available.

14. The definition of EIR in Appendix A of IFRS 9 states it clearly that **all** contractual terms and conditions shall be considered in the EIR calculation. Although there is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably, IFRS 9 acknowledges that, 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), an entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

15. Given that the differences in accounting outcomes are not caused by a lack of clarity in IFRS 9, it follows that such differences would not be effectively resolved through standard-setting by the IASB. Accordingly, we think the IASB should not take any further action on this matter.

How to consider conditional terms in EIR calculation

16. Although IFRS 9 has no explicit requirements or guidance about the methods of estimating expected cash flows for purposes of calculating EIR, as described in paragraph 10, the feedback from the 2025 outreach suggests that entities generally use either the most likely outcome or the probability-weighted outcomes (expected value) approach.

17. Outreach participants said that they determine the most appropriate method to use for considering conditional terms into the EIR calculation based on specific facts and circumstances, such as the nature of the conditional terms and depending on whether they are estimating cash flows for a group of financial instruments or for single instruments.

18. As noted in the Agenda Paper 11A of the June 2025 IASB meeting, most participants in the 2025 outreach said that the IASB should not prescribe a specific method for

considering contractual terms and conditions into the EIR calculation. A few of these participants suggested that any potential clarifications for this matter should at least be consistent with the principles in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or in IFRIC 23 *Uncertainty over Income Tax Treatments*.[2]

19. As noted in the background section of this paper, similar feedback was received in response to the proposal in the 2009 Exposure Draft which required entities to use the probability-weighted outcomes approach for determining EIR.

20. We agree that a 'one-method fits all' approach would not be an effective solution. That is, although prescribing a particular method to use in all circumstances would reduce potential diversity in practice, it might not result in a reliable estimate and consequently, it would not provide useful information about future cash flows. Accordingly, it would not be an improvement in financial reporting. It might also result in undue change in practice for some entities, ie entities being required to change estimation method to one that is not reflective of the facts and circumstances for particular financial instrument(s).

21. Instead of prescribing a particular method, the IASB could consider adding application guidance to IFRS 9 to assist entities in applying judgement on a more consistent basis and facilitate auditing and enforcement processes. For example, guidance similar to that in paragraphs 39–40 of IAS 37, outlining circumstances in which a method might be more appropriate than others.

22. This could also mean that recurring application questions, such as the question about how to determine the EIR for TLTRO III transactions or for ESG-linked instruments, might be addressed.

[2] Paragraphs 39–40 of IAS 37 provide principles about determining a best estimate in context of the amount recognised as a provision, stating that uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Methods of estimation such as probability-weighting, the mid-point of the range, or the most likely outcome are mentioned alongside circumstances where their use would be appropriate for purpose of determining the best estimate of the liability. Similarly, paragraph 11 of IFRIC 23 requires that an entity reflect the effect of uncertainty for each uncertain tax treatment by using either the most likely amount or the probability-weighted method, depending on which method the entity expects to better predict the resolution of the uncertainty.

23. However, consistent with the project criteria discussed in its February 2025 meeting, the IASB would need to determine whether financial reporting would be improved through such guidance and whether overall, these improvements would bring a meaningful change in practice (ie achieve the objective of reducing diversity in practice).

24. Feedback from the 2025 outreach suggests that, generally, entities are already exercising judgement in choosing the most appropriate method to use based on specific facts and circumstances and that they commonly apply the guidance in IAS 37 by analogy.

25. Consequently, we are of the view that potential amendments to IFRS 9 on this area would be unlikely to bring any meaningful improvement in practice. Accordingly, we think the IASB should not take any further action on this matter.

Appendix A— Review of accounting firms' manuals

A1. We reviewed the accounting manuals of the large accounting firms to collect information about their views on application of IFRS 9 requirements to determine the EIR at initial recognition for financial instruments with conditions attached to the contractual interest rates.

A2. Two accounting firms noted that IFRS 9 does not contain clear guidance on how the expected cash flows are estimated when calculating EIR. For example, it is unclear how to reflect conditionality attached to the contractual interest rate in the EIR. They are of the view that expected cash flows could be estimated either using the most likely outcome or a probability-weighted outcomes approach.

A3. One accounting firm noted that in determining which estimation technique to use (ie the most likely outcome or a probability-weighted outcomes), an entity could consider the principles in IAS 37 for determining a best estimate, as well as the principles in IFRIC 23 which allows an entity to use whichever method better predicts the resolution of the uncertainty.

A4. One accounting firm observed that in most cases, the EIR is calculated based on a single point estimate, which is more operationally straightforward. However, this firm noted that there can be some uncommon cases where such methods may not provide the most useful outcome.