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Amendments to the Classification and Measurement of Financial Instruments- Feedback analysis - Assessment of contractual cash flows

Objective

1 The objective of this paper is to provide the EFRAG FR TEG with a summary of the updated proposals of the IASB staff on the assessment of contractual cash flows (Question 2 of the ED).

Summary of the IASB staff recommendations

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

3 The IASB staff also recommends **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.

4 The IASB staff further recommends **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.

Structure of this paper

5 The IASB staff analysis is summarised in paragraph 10 to 30.

6 IASB discussion on 23 January 2024 is summarised in paragraph 31 to 38.

7 EFRAG Secretariat assessment of the IASB staff analysis and IASB discussion is provided paragraph 39 to 45.

8 EFRAG FR TEG discussions on 5 December 2023 are summarised in paragraph 46 to 50.

9 Questions to EFRAG FR TEG are presented in paragraph 51 to 53.

IASB staff analysis

The amount of compensation an entity receives

10 The IASB staff agrees 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.

11 Nevertheless, the IASB staff believes 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.

The interaction between different SPPI requirements

12 There are financial assets, notably those with ESG-features, 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.

13 In its proposed clarifications in the ED, the IASB established robust principles to support the current requirements in IFRS 9, including:

(a) The cash flows before and after the contingent event(s) are SPPI, i.e. that those cash flows can be determined or are known (paragraph B4.1.10 of IFRS 9);

(b) The probability of the contingent events (unless it is non-genuine) is not considered in the assessment (paragraph B4.10A of the ED);

(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).

14 Paragraph B4.1.10 of IFRS 9 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). 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. E.g., if cash flows change in response to an underlying variable such as an equity index, this introduces exposure to risks or changes in cash flows that are unrelated to a basic lending arrangement.

15 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**.

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

16 In an attempt to answer the question in paragraph 15, the IASB staff previously considered 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.

17 However, on further reflection the IASB staff acknowledges 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 a particular scenario referred to in that paragraph.

18 In general, 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. In the view of the IASB staff, **some of these scenarios** (e.g., 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) would not be inconsistent with a basic lending arrangement and **give rise to a financial asset with contractual cash flows that are SPPI**. On the contrary, **other scenarios** (eg., when the probability of the contingent event causing a change in cash flows is low (even if the adjustment isn't small) or when 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)) would be inconsistent with a basic lending arrangement and **would not give rise to a financial asset with contractual cash flows that are SPPI.**

19 Instead, the IASB staff proposed that 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 the view of the IASB staff, 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

20 In following the proposed direction, questions arise as to 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.

21 The purpose of the 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. 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.

22 The IASB staff notes 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, 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 (i.e. assume that every contingent event occurs), not only those which are reasonably possible.

23 In the view of the IASB staff, such a requirement, in practice, would not necessarily require a detailed assessment on an individual basis.

24 The IASB staff considers that the **threshold** to use in assessing the difference in the cash flows due to the contingent event (ie. what constitutes '**significantly different'** in this context) would be **developed by the entities their own internal policies**. The IASB staff refers to the application guide to IFRS 9 which contains various examples of quantitative concepts without defining specific quantitative thresholds (paragraphs B4.1.3B, B4.1.9C and B4.1.11(b) of IFRS 9). According to the observations in the PIR feedback, 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.

25 To avoid unintended consequences (ie. wrongful conclusions that the instruments have SPPI cash flows while in reality they do not) the IASB staff emphasises 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; 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.

26 The IASB staff considers that it is useful to note the difference between the mentioned requirement and the existing 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 minimis impact** on the cash flows': (1) The de minimis principle applies to all contractual features whereas the recommended requirements would only apply in specific cases; and (2) 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

27 The IASB staff acknowledges that the analyses of the **proposed examples the ED should be updated** to illustrate the application of the updated requirements.

28 The IASB staff does 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. However, the analysis is to be updated to take into account proposed refinements of paragraph 25.

29 The IASB staff recommends 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 25.

30 **The IASB staff does not believe that additional examples** (e.g. 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 be useful**, because the refinements proposed to the clarifications in IFRS 9 do not focus on the nature of the contingent event.

The IASB members discussion

31 The IASB discussed the IASB staff recommendations at its January meeting. Members generally expressed support for the direction of travel and the IASB staff recommendations.

32 An IASB member questioned how a situation with multiple contingent events should be analysed, e.g. should they be analysed individually or on an aggregated basis. The IASB staff explained that all genuine contractually possible scenarios must be analysed both on aggregated basis and individually (eg. in case of mutually exclusive contingent events).

33 IASB members, with limited exceptions, agreed that the nature of the proposed amendments is clarification of existing model, not a fundamental change to the existing requirements. Also, several IASB members emphasised that a timely solution was found for the PIR issue which was formulated in September 2022 (therefore, it took around 1,5 years to arrive at the stage of final amendments).

34 An IASB member, whilst agreeing with the technical analysis, disagreed, from an economic standpoint, with creating a signalling mechanism for financial instruments with features "insignificant" for their economic consequences. He also noted that the current approach may be interpreted as widening the de minimis criteria. The staff replied that (1) the purpose of SPPI is analysis of the cash flows, not of the economic effects of the instruments; (2) advocated the use of the term "not significant" rather than "insignificant" and especially "de minimis" (which is equal to "negligeable") when dealing with the difference between the cash flows before and after the contingent events.

35 An IASB member observed that, given that the amendments concern non-financial entities as well as banks as well as unpredictable evolution in the future of the financial instruments in question, as much guidance as possible should be made available via Basis for Conclusions, Application guidance and examples.

36 Several IASB members had concerns about the use of the term "investment in the debtor" in the paragraph B4.1.10A which would need to be further aligned with the wording in paragraph B4.1.16. The IASB staff agreed that the exact wording will be further refined and aligned but the general idea was that cash flows that are SPPI should not include any share of revenue or profit or any proxy of that. An IASB member proposed to include a relevant explanation into the Basis for Conclusions.

37 The IASB tentatively decided **to finalise the proposed amendments in the ED, subject to revisions**, namely:

(a) Clarifying, in relation to paragraph B4.1.8A of the ED, that the amount of compensation that an entity receives may indicate that the entity is being compensated for something other than basic lending risks or costs;

(b) Instead of requiring that a contingent event should be specific to the debtor, as set out in paragraph B4.1.10A of the ED, specifying that, if the nature of a contingent event is not directly related to a change in basic lending risks or costs, a financial asset has contractual cash flows that are solely payments of principal and interest if: (i) irrespective of the probability of the contingent event occurring, the contractual cash flows before and after any contingent event(s), when considered in isolation, are solely payments of principal and interest; and (ii) the contractual cash flows arising from a contingent event are not significantly different from the cash flows on a similar financial asset without such a contingent event and do not represent an investment in particular assets or cash flows; and

(c) Updating the analyses of the proposed examples in the Exposure Draft to illustrate the application of the changed requirements.

38 13 of 14 IASB members agreed with this decision.

The EFRAG Secretariat assessment

39 The EFRAG Secretariat welcomes the IASB's intention to finalise the proposed amendments in the ED, subject to the refinements, taking into account that a solution is expeditiously needed.

40 The EFRAG Secretariat notes that multiple concerns were previously expressed with regards to the approach based on an assessment whether the fair value of the contractual feature is insignificant at initial recognition (some of these concerns are summarised by the IASB staff in paragraph 18).

41 Therefore, the EFRAG Secretariat welcomes the IASB's decision in favour of a different approach which is based on the assessment of the cash flows as SPPI or not before and after the contingent event, as well as comparing contractual cash flows of an instrument with the contingent feature with those of an instrument without such a feature, as detailed in paragraph 37. This approach may be applied beyond the immediate issue of instruments with ESG-features.

42 However, the EFRAG Secretariat has two concerns (a) that the test of cash flows before and after the contingent event(s) is not able to define any cash flows as non-compliant and thus is unnecessary and (b) that after the requirement for a contingent event to be specific to the debtor was removed from paragraph B4.1.10A of the ED, the range of instruments which will be recognised as SPPI widens further. This may have unintended consequences in the future, e.g., in case of instruments with conditions which go beyond ESG-features that are currently observed in the market. Whilst amortised cost may currently seem a preferred measurement model for such instruments, evolution of financial instruments may subsequently lead to a different view.

43 The EFRAG Secretariat also shares some of the concerns raised by the IASB Board members in their discussions, e.g. regarding "widening de minimis criteria" (paragraph 34). While the proposed approach is based on comparison of the contractual cash flows of an instrument with a contingent feature with those of a similar instrument without such a feature (and the difference between these cash flows is required to be not significant rather than de minimis), its introduction may result in the de minimis principle being absorbed by this new requirement. In effect, the instruments with de minimis features will be accepted as SPPI on the basis of comparison of the cash flows of the instruments with and without the contingent feature (if the difference is not significant), so the de minimis test may become excessive.

44 In addition, the EFRAG Secretariat shares, to a certain extent, the concern of an IASB member (paragraph 34) that referring to the contingent events as ''insignificant'' may unintentionally send a wrong message to the market.

45 As mentioned at an earlier stage, the EFRAG Secretariat notes that the wording 'an investment in particular assets or cash flows' from paragraph B4.1.16 of IFRS 9 is more general than the original proposal and highlights the importance of careful drafting to avoid unintended consequences. The EFRAG Secretariat agrees that, for avoidance of doubt, it would be useful to include further explanations of the wording and the IASB staff argumentation into the Basis for Conclusions as proposed by an IASB member (paragraph 36).

EFRAG discussions

46 EFRAG FR TEG discussed this topic at its meeting on 5 December 2023. Its feedback is provided below.

EFRAG FR TEG

47 Members noted that the IASB staff new proposal to evaluate a significance of a fair value of a contingent feature was a significant change. Although theoretically it seems to be a good solution, members expressed concerns about its practical application. They noted that evaluating fair value of a contingent feature would be difficult and questioned how it could be done in qualitative way. One member suggested the IASB to perform an outreach on this proposal. However, members noted that it was an important change, expressed concerns about quantification of the insignificance of a contingent feature and questioned how it could be done in a qualitative way.

48 Some members asked whether it could be seen as a relaxation of a de-minimis constraint and welcomed the IASB decision not to continue with 'specific to the debtor' requirement. Some members further questioned whether and how they should estimate a fair value of a loan with and without a contingent feature if currently there is no requirement to do so.

49 A member questioned about a message that will be given to the market if an entity concludes that fair value of a sustainability feature present in all of this entity's financial instruments is insignificant.

50 Members highlighted the challenge for the IASB to move fast and at the same time to have a broad support for a suggested solution.

Questions for EFRAG FR TEG

51 Does EFRAG FR TEG have any comments on the IASB staff proposed clarifications to the paragraph B4.1.8A of IFRS 9 described in paragraph 37(a)?

52 Does EFRAG FR TEG have any comments on the IASB staff proposed clarifications to the paragraph B4.1.10A of IFRS 9 described in paragraph 37 (b)? In particular, does EFRAG FR TEG agree with the decision of the IASB to replace the approach based on an assessment whether the fair value of the contractual feature by the one based on comparison of the cash flows before and after the contingent event?

53 Does EFRAG FR TEG have any other comments or concerns with regards to the final proposals of the IASB?