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STAFF PAPER

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Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Paper topic	Summary of feedback from phase 1 outreach

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Purpose of this paper

1. This paper summarises feedback from outreach in phase 1 of the post-implementation review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments*.

2. The purpose of gathering this feedback is to assist the International Accounting Standards Board (Board) in identifying matters to gather further information on in the form of a request for information (RFI) (see Agenda Paper 3C). The Board will analyse responses to the RFI in phase 2 of the PIR to assess whether the classification and measurement requirements in IFRS 9 are working as intended, and what, if any, actions the Board will take as a result of the findings of the PIR.

3. This paper does not include questions for Board members. See Agenda Paper 3C for questions for Board members. We welcome any comments or questions on the feedback summarised in this paper.

Structure of this paper

4. This paper summarises general feedback on the application of the classification and measurement requirements, as well as specific feedback on the following areas of the requirements:

   (a) business model assessment for financial assets;

(b) contractual cash flow characteristics assessment for financial assets;

(c) option for equity instruments to present fair value changes in other comprehensive income (OCI);

(d) financial liabilities;

(e) modifications to contractual cash flows; and

(f) transition to IFRS 9.

Summary of feedback

5. Suggestions on the specific matters the Board should examine in the PIR have generally been very consistent across the various stakeholder groups we have spoken to in phase 1 of the PIR.

6. Most stakeholders said that generally the classification and measurement requirements are working well in practice. Stakeholders specifically commented that:

   (a) the conceptual approach to classification in IFRS 9 is an improvement on the rules-based approach that applied previously under IAS 39 *Financial Instruments: Recognition and Measurement*. The requirements are simpler, and the connection between the classification requirements and the measurement approach is logical.

   (b) for many stakeholders the impact of the changes introduced by the classification and measurement requirements in IFRS 9 has not been significant. Many financial assets measured at amortised cost applying IAS 39 continue to be so applying IFRS 9, and many financial assets measured at fair value applying IAS 39 continue to be so applying IFRS 9. As an example, one entity told us that 96 per cent of their debt financial assets maintained the same classification on initial application of IFRS 9.

7. However, some users of financial statements and academics said that IFRS 9 is complex and thus difficult to understand. Users of financial statements' comments related mostly to understanding inputs into fair value measurement as opposed to understanding the requirements in IFRS 9. Academics' comments related mostly to IFRS 9 being longer and more detailed than some other IFRS Standards. Both groups

however generally acknowledged the inherent complexity involved in accounting for financial instruments, which come in many forms and are often complex in nature.

8. Generally, the specific matters stakeholders suggest the Board examine in the PIR (summarised in the following sections of this paper) are matters for which stakeholders think the Board should:

   (a) consider whether a specific area of the requirements could benefit from additional application guidance or clarification to support consistent application; or

   (b) reconsider the rationale behind a specific area of the requirements for which some stakeholders continue to disagree with a decision the Board made when it developed IFRS 9 (for example, because those stakeholders' conceptual views differ from those of the Board).

A. Business model assessment for financial assets

Background

- The business model assessment aligns the measurement of financial assets with the way the entity manages those assets to generate cash flows (that is, from collecting contractual cash flows, selling financial assets or both).
- There are no prescriptive 'bright lines' between the different business models in IFRS 9. Rather, an entity needs to consider all relevant information and evidence available to make the assessment.
- The business model is a matter of fact and not merely an assertion or management's intention for an individual financial instrument.
- Financial assets are reclassified after initial recognition if, and only if, there has been a change in business model. A change in business model must be significant to the entity's operations, demonstrable to external parties and is expected to be very infrequent. This restriction responds to concerns from users of financial statements about comparability, and that opportunistic reclassification could be used to achieve a particular accounting result.

Overview of feedback

9. Generally, stakeholders provided less feedback on the business model assessment compared to the contractual cash flow characteristics assessment. Some stakeholders said that the business model assessment is working well, and they are not aware of any significant application questions arising since the Standard was issued.

10. Most feedback on the business model assessment related to:

    (a) the application of judgement in performing the business model assessment (see paragraphs 11–12 of this paper); and

    (b) reclassification of financial assets after initial recognition (see paragraphs 13–18 of this paper).

Applying judgement

11. Most stakeholders said the business model assessment is well understood and the distinction between the different business models is clear. However, some other stakeholders expressed concern that there may be diversity in practice resulting from the judgements needed to do the business model assessment. They specifically mentioned possible diversity related to:

    (a) the level at which the business model is assessed; and

    (b) how the frequency and significance of sales are considered in determining the business model.

12. In addition, a regulator expressed concern that some entities' accounting policies for the business model assessment allows flexibility and overlap between the different business models within one individual entity. For example, applying the policy an individual asset could be classified as either 'held to collect' or 'held to collect and sell'. This could create the risk that similar assets held for the same reason are classified differently.

Reclassification of financial assets after initial recognition

13. Stakeholders said that, as the Board had expected, reclassification of financial assets has been rare. Stakeholders commented that the requirement in IFRS 9 for a change in business model to be demonstrable to external parties sets a high bar for reclassification, as was intended. The only example shared with us of an actual

situation in which there has been a change in business model is on the sale of an entity to a new parent entity.

14. However, one regulator said that, although rare, they had seen reclassification that in their view resulted from incorrect application of the Standard, rather than from a lack of clarity of the Standard. They said that they had faced several cases in which the business model assessment made by the entity at initial recognition did not align with the way the entity managed the financial assets subsequently. The example they gave is of an entity that has a portfolio of debt financial assets classified at amortised cost because it considers their business model is to collect contractual cash flows but, finally, the entity sells a significant amount of the financial assets for reasons other than increased credit risk.

15. Some feedback suggested that there are mixed views about whether changes in sales expectations, or the prudential regulatory treatment of financial assets, due to the covid-19 pandemic are sufficient to trigger reclassification.

16. Some users of financial statements and regulators continued to express support for the restriction on reclassification, as it avoids opportunistic reclassifications. However, some other stakeholders expressed a view that the restriction on reclassifying financial assets could reduce the usefulness of information provided to users of financial statements in some circumstances.

17. One example of a situation for which some stakeholders are of the view that the requirements for reclassification should be less restrictive is for loan syndications. Prior to syndication, the entity determines the portion of the loans it intends to retain and the portion it intends to sell. The entity classifies the portion it intends to retain as ‘hold to collect’ (amortised cost if SPPI), and the portion it intends to sell as ‘managed on a fair value basis’ (fair value through profit or loss). The issue that stakeholders have raised relates to circumstances when the entity cannot sell the full portion it had intended to sell. In those circumstances, those stakeholders think the entity should be permitted to reclassify the portion it was not able to sell as ‘hold to collect’. Alternatively, some stakeholders suggested the Board amend IFRS 9 to permit a grace period (for example 3 months after initial recognition) for an entity to determine the business model within which financial assets will be managed.

18. Other situations some stakeholders suggested an entity should be permitted to reclassify financial assets include circumstances when:

(a) an entity has used the fair value option to reduce an accounting mismatch, and subsequently that accounting mismatch no longer exists, for example when the related liability has been derecognised.

(b) in a banking group, in the context of liquidity management, securities are purchased by an investment banking department and are sold internally to the retail department (of the same group). Some stakeholders said that at the acquisition date, those assets are held within a business model that is neither 'held to collect' or 'held to collect and sell' and thus are measured at fair value through profit or loss. However, after being transferred to the retail department the entity expects to hold the assets to collect contractual cash flows.

(c) the market is in a period of stress, resulting in lower than expected sales volumes or quantities or a change in the prudential regulatory treatment of financial assets (for example financial assets no longer qualify as part of the liquidity buffers).

B. Contractual cash flow characteristics assessment for financial assets

Background

- Amortised cost is a simple measurement approach that provides useful information only for financial assets with contractual cash flows that are solely payments of principal and interest (SPPI).
- Fair value measurement is required to ensure the reported financial information provides useful information about the amount, timing and uncertainty of more complex cash flows that are not SPPI.
- The objective of the contractual cash flow characteristics assessment is to identify financial assets for which effective interest method, which underpins amortised cost measurement, provides useful information, and those financial assets for which it does not.

> – IFRS 9 provides extensive application guidance on assessing whether contractual cash flows are SPPI. This includes specific requirements about assessing the cash flows of contractually linked instruments (tranches or concentrations of credit risk) that are created by transactions in which an issuer prioritises payments to holders of financial assets using multiple contractually linked instruments.

Overview of feedback

19. With regards to the application of the contractual cash flow characteristics assessment generally, stakeholders did not raise any transactions or contractual features for which they think the SPPI requirement results in the 'wrong measurement approach' being applied. However, the majority of the feedback in phase 1 was raised on the question of whether there is sufficient application guidance in IFRS 9 to apply the requirements consistently. Many stakeholders said that they see the PIR as a good opportunity for the Board to assess whether the principle-based requirements are 'future proof'—ie, that the requirements can be applied consistently and appropriately as markets develop and new product features emerge.

20. Feedback related mostly to:

    (a) the application guidance for contractually linked instruments (CLIs) (see paragraph 22–24 of this paper); and

    (b) applying the SPPI assessment to loans with interest rates linked to sustainability targets (see paragraphs 25–29 of this paper).

21. In addition, some stakeholders drew attention to the application of the SPPI assessment to instruments with mismatches in the timing of reset as a result of IBOR reform, loans that have interest rates linked to rates other than benchmark rates, non-recourse instruments, and debt instruments that can be prepaid before the maturity date.

Investments in contractually linked instruments (tranches)

22. Some stakeholders suggested that the application guidance for CLIs may be interpreted as applying to a wider population of scenarios than the Board had

intended. In that context, some stakeholders questioned what is meant by the terms 'multiple', 'tranche', 'contractually linked' and 'concentration of credit risk' in paragraph B4.1.20 of IFRS 9. That paragraph states:

> In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentration of credit risk (tranches). …

23. Some stakeholders also raised questions about:

    (a) the distinction between contractually linked instruments and non-recourse financing; and

    (b) whether the CLI requirements apply to all financial instruments that are subject to subordination.

24. Those stakeholders suggest the Board determine as part of the PIR whether the requirements are being applied consistently, and, based on the outcome, consider providing additional application guidance or educational material to enable more consistent application.

Loans with interest rates linked to sustainability targets

25. Many stakeholders said that, at present, practice is developing with regards to analysing whether a loan with an interest rate linked to the achievement of sustainability targets has cash flows that are SPPI.

26. Loans with these features are relatively new to the market and their prevalence is expected to continue increasing over the coming years. Stakeholders explained that these loans terms vary, and often the terms are tailored specifically to the customer. Generally, the loans include an interest rate incentive or penalty depending on whether the customer meets a specified environment, social, or corporate governance (ESG) target. For example, if the customer meets its target for reducing its carbon footprint or increasing Boardroom diversity in a particular period, the interest rate for the following period is reduced by a specified amount. Stakeholders have said that at present, the incentive typically ranges between 2.5bps–10bps. However, some stakeholders expect the size of the incentive to increase as these products become more prevalent in the market.

27. Stakeholders suggested that the Board examine in the PIR how the SPPI assessment applies to these loans. In their view, this would be both helpful to entities currently developing their assessment approach, and to the Board in assessing whether the requirements in IFRS 9 are capable of being applied consistently and appropriately to new products. Generally, these stakeholders had mixed views on whether:

   (a) there is sufficient application guidance in IFRS 9 to enable an entity to apply the SPPI requirements; and

   (b) the outcome of applying the current requirements in IFRS 9 is appropriate (ie provides the most useful information to users of financial statements).

28. Some other stakeholders suggested the Board urgently look to provide guidance on these loans, separate to the PIR.

29. This topic was the most recurrent topic raised during outreach, and a number of stakeholders shared with us the types of questions they are working through in their accounting analysis. Given the significant amount of feedback we have received on this topic, Agenda Paper 3B supplements this paper by providing further detail from the feedback, and preliminary staff views.

C. Option for equity instruments to present fair value changes in OCI

Background

– Equity instruments, by default, are measured at fair value through profit or loss because they have cash flows that are not SPPI. They have no contractual cash flows to amortise, which forms the basis of effective interest method used for amortised cost and fair value through OCI measurement categories.

– However, IFRS 9 permits an entity to irrevocably elect on initial recognition to present fair value changes of particular investments in equity instruments in OCI.

– To be eligible the instrument must meet the definition of equity in IAS 32 and not be held for trading.

- The option to present fair value changes in OCI for equity instruments was created for unusual cases in which changes in the fair value of an equity instrument may not be indicative of the entity's performance, for example, when the entity holds the investment for strategic reasons.
- If an entity presents fair value changes in OCI, gains and losses are not reclassified ('recycled') to profit or loss on derecognition of the equity instrument because this presentation option was designed for circumstances in which these fair value changes are not relevant to profit or loss. In addition, recycling would create the need to assess these equity instruments for impairment.
- IFRS 9 does not contain impairment requirements for investments in equity instruments including those for which fair value changes are presented in OCI.

Non-recycling of gains and losses

30. One regulator said that previously, some listed companies with excess cash could purchase equity instruments and classified them as AFS applying IAS 39 to avoid volatility in profit or loss, and then later opportunistically sell the instruments to manage earnings by realising gains in profit or loss in periods of poor performance. That regulator said that adoption of IFRS 9 (and thus removal of the AFS category) has put a stop to that behaviour.

31. Some stakeholders felt strongly that the Board should reconsider the 'non-recycling' of gains and losses on equity instruments classified as fair value through other comprehensive income. Those stakeholders continued to express disagreement with the Board's rationale for this requirement and expressed the view that the prohibition from recycling could have a detrimental effect on long-term investment decisions. In their view, recycling of gains and losses from OCI to profit or loss on the sale of long-term investments would reflect the performance achieved in line with the long-term business model.

32. We asked stakeholders how the removal of the available for sale category in IAS 39 (which required recycling of such gains and losses on disposal) had affected entities'

investment decisions (ie nature and type of investment). We have not yet received any information that would suggest that this change has affected entities' investment decisions.

33. One entity told us that on transition to IFRS 9 equity instruments carried at fair value through profit or loss increased sharply due to the removal of the AFS category. They said that this led to increased volatility in earnings, and consequently the entity has improved its regular stress testing and sensitivity analysis, as well as forward-looking analysis and active management of possible changes in markets.

Prevalence of the use of the OCI presentation election

34. We asked stakeholders how prevalent the use is of the option for equity instruments to present fair value changes in OCI. We were told that some entities are using the option for so called 'strategic investments' consistent with the Board's intention. We were also told that some entities choose *not* to use the option for strategic investments because they are deterred by the prohibition from recycling gains and losses under that option. They said that strategic investments are not always held indefinitely and, on disposals of those investments, they would want the disposal gains and losses to be reflected in profit or loss.

35. One entity explained to us that they had established criteria for using the election based on whether an investment is long-term or short-term. An example they provided of a long-term holding (for which the OCI presentation election was made), is a stock with high dividend distribution whereby the entity intends to earn long-term profits mainly through receiving a stable cash dividend.

Scope of the option to present fair value changes in OCI

36. Some stakeholders commented on the scope of the presentation election. Some stakeholders suggested IFRS 9 should explicitly limit the exception to apply only to strategic investments or investments held for non-financial reasons. Some other stakeholders expressed disagreement with the election being made only at initial recognition and being irrecoverable.

D. Financial liabilities

Background

- The classification and measurement requirements for financial liabilities in IFRS 9 are essentially unchanged from IAS 39, except that IFRS 9 solves the so called ‘own credit issue’ for financial liabilities designated as at fair value through profit or loss.
- For those financial liabilities, the effects of changes in the fair value of an entity’s own credit risk are presented in OCI unless such presentation would create or enlarge an accounting mismatch in profit or loss.

Overview of feedback

37. We received little feedback in this area. Generally, stakeholders expressed positive feedback about the own credit requirement, with some stakeholders saying that it was a key improvement introduced by IFRS 9. However, some stakeholders commented on the measurement aspects and said that in can be difficult in practice to separately identify and measure the fair value changes arising from changes in own credit risk.

38. Some stakeholders also expressed the view that the scope of the own credit requirement could be wider—that is, in their view, it should apply to more financial liabilities measured at fair value through profit or loss, rather than only those designated under the fair value option (and for which applying the requirement would not create or enlarge an accounting mismatch in profit or loss).

E. Modifications to contractual cash flows

Background

- When contractual cash flows are renegotiated or otherwise modified, this could result in either derecognition of the financial instrument or alternatively in recalculation of the (gross, if financial assets) carrying amount of the financial instrument.
- When finalising the IBOR amendment, the Board noted inconsistency in the wording used for financial assets and financial liabilities.

Overview of feedback

39. Some stakeholders suggested the Board review whether the application guidance in IFRS 9 for modifications is sufficient to enable consistent application. Specific issues mentioned by stakeholders included the distinction between modification and derecognition, and the drafting of the requirements for financial assets. Some stakeholders expressed the view that the inconsistencies in drafting highlighted during the IBOR project need to be resolved.

40. Other stakeholders expressed a view that there were no significant issues with the application of the requirements. Those stakeholders noted that the requirements were substantially carried forward from IAS 39, and thus entities have been using them for many years and practice is well developed.

41. Some stakeholders said that, to reduce diversity in practice, the Board should clarify whether the assessment in paragraph B3.3.6 of IFRS 9 for financial liabilities (the so-called 10 per cent test) is required or permitted to be applied to *financial assets*. Stakeholders expressed mixed views about whether this is an appropriate analogy, especially when considering the interaction with the requirements for expected credit losses.

F. Transition to IFRS 9

Background

- Entities were required to apply the classification and measurement requirements of IFRS 9 retrospectively on the date of initial application (ie 1 January 2018 for many entities).
- Entities were permitted some transition reliefs and exceptions from full retrospective application of the Standard.
- Entities were permitted, but not required, to restate comparative information on initial application of the Standard (permitted only if possible without hindsight).

Overview of feedback

42. We received little feedback in this area. Some stakeholders said that in their view the transition requirements were appropriate and the disclosures were useful.

43. One preparer said that an area of challenge for them was performing the SPPI assessment based on contractual cash flows at initial recognition of the financial asset. The preparer noted that this assessment was easily done for standard bonds, but the challenge lay with other investments because the terms of contracts varied widely and as such the assessment required review of the contractual terms for each individual financial instrument.

44. IFRS 7 *Financial Instruments: Disclosures* sets out the information entities are required to disclosure on initial application of IFRS 9. Some users of financial statements commented that these disclosures were extremely useful in helping them to understand how financial instruments were reclassified under IFRS 9. Those users noted that what was particularly useful, was that the transition disclosures were a combination of quantitative and qualitative information.