IFRS

STAFF PAPER

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Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Paper topic	Identifying matters to examine in phase 2

CONTACT(S)	Laura Kennedy	lkennedy@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Purpose of this paper

1. Agenda Papers 3A and 3B summarise feedback from outreach in phase 1 of the post-implementation review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments*.
2. This paper provides preliminary staff analysis, recommendations, and questions for Board members on which matters to examine in phase 2 of the PIR and thus ask questions about in the Request for Information (RFI).

Summary of staff recommendations

3. The questions in the RFI will be set within the context of the feedback from phase 1 outreach and within the context of the Board assessing:
   (a) whether the requirements are working as intended;
   (b) whether the requirements are capable of being applied consistently; and
   (c) if there are any significant unexpected effects.
4. The staff recommend the Board examine further in phase 2, and thus ask questions in the RFI, about the following matters:
   (a) *Business model assessment for financial assets:*

   (i) application of judgement in applying the business model assessment; and
   (ii) reclassification of financial assets due to a change in business model.

(b) *Contractual cash flow characteristics assessment for financial assets:*
   (i) applying the assessment in the light of market developments (including new product features); and
   (ii) investments in contractually linked instruments (CLIs).

(c) *Option for equity instruments to present fair value changes in other comprehensive income (OCI):*
   (i) prevalence of the use of the presentation option and types of instruments it is used for; and
   (ii) effect of the option on entities' investment decisions and on the usefulness of information to users of financial statements.

(d) *Financial liabilities designated as fair value through profit or loss:*
   (i) presentation of changes in fair value due to changes in own credit risk in OCI.

(e) *Modifications to contractual cash flows:*
   (i) differences in drafting between the requirements for modifications for financial assets and financial liabilities; and
   (ii) determining when a modification results in derecognition.

(f) *Transition to IFRS 9:*
   (i) effects of transition reliefs provided; and
   (ii) balance of reducing costs for preparers of financial statements and providing useful information to users of financial statements.

Structure of this paper

5. This paper provides preliminary staff analysis, recommendations and questions for Board members on each of the following topics:

(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 OCI;

(d) financial liabilities;

(e) modifications to contractual cash flows;

(f) transition to IFRS 9.

Staff analysis and recommendations

6. As explained in Agenda Paper 3, the objective of this PIR is to:

   (a) assess whether the requirements have improved financial reporting (without disproportionate cost); and

   (b) identify lessons learned that will help the Board in its efforts to continuously improve its standard-setting.

7. To assess whether the requirements have improved financial reporting, the Board is considering:

   (a) whether the requirements are working as intended;

   (b) whether the requirements are capable of being applied consistently; and

   (c) if there are any significant unexpected effects.

8. In the staff analysis in this paper, we have used these considerations as a framework to analyse feedback for the purpose of determining the scope of the RFI.

9. In addition to the RFI asking questions on the specific topics discussed in this paper, the staff intend that the RFI will ask if stakeholders have any other feedback relevant to the Boards assessment of the questions in paragraph 7 of this paper.

A. Business model assessment for financial assets

10. See section A of Agenda Paper 3A for background and a summary of feedback on this topic.

Applying judgement

11. As stakeholders noted in outreach, assessing the business model of financial assets requires an entity to apply judgement—particularly in relation to the level at which the business model is assessed and how to factor in the significance and frequency of sales into the assessment.

12. As noted in paragraph BC4.18 of the Basis for Conclusions on IFRS 9, the Board aimed to avoid necessitating *significant* judgement to determine the business model. However, stakeholders expressed the view that the Board should avoid bright lines and that an entity should be required to exercise judgement. As such, there are no bright lines between the different business models, rather an entity needs to consider all relevant evidence available to make the assessment.

13. In the staff view, gathering further information on entities' approaches to applying the requirements for which judgement is needed will help the Board in assessing whether the requirements are capable of being applied consistently. Therefore, the staff recommend the Board ask questions in the RFI on this matter. For example, we think it will be helpful to gather information on:

    (a) the level at which the business model assessment is being made;

    (b) how the significance and frequency of sales are being factored into the business model assessment; and

    (c) what, if any, diversity in practice exists, how pervasive the diversity is and the effects of the diversity.

14. However, we note that *applied consistently* does not mean *applied identically*. Financial assets come in many shapes and sizes, and approaches to managing financial assets differ between entities and between different markets. As such, the fact that entities consider different factors when making their assessment does not necessarily indicate that the requirements are not being applied consistently. Rather, an indication of inconsistent application would be entities reaching different conclusions on the same set of facts and circumstances in the same context.

Reclassification of financial assets after initial recognition

15. As explained in paragraphs BC4.111–BC4.114 of the Basis for Conclusions on IFRS 9, the Board considered prohibiting reclassification all together, but was persuaded that in an approach based on business model, reclassification when there has been a change in business model would result in the most useful information about the amounts, timing, and uncertainty of future cash flows.

16. Feedback from outreach suggests that, as the Board expected, reclassification between business models has been rare.

17. However, some feedback suggested mixed views are held on whether changes in sales expectations due to the covid-19 pandemic result in reclassification. The staff note that a change in business model is a significant event demonstrable to external parties and is not merely a change in management's intention for a specific financial asset. As such, a change in sale expectations on its own is not a change in business model.

18. Some stakeholders suggested various situations in which they think an entity should be permitted or required to reclassify financial assets when there has not been a change in business model (see paragraphs 17–18 of Agenda Paper 3A). The preliminary staff view is that the situations described appear to be situations in which management's intention for a specific financial asset has changed. In the Board's view, permitting or requiring reclassification due to a change in management's intention for a specific financial asset would reduce rather than improve the usefulness of information provided to users of financial statements. Frequent reclassification would increase complexity for users of financial statements and would create a risk of opportunistic reclassification.

19. The staff note that because it appears that suggestions relate to circumstances when management's intention for a specific financial asset changes subsequent to initial recognition, it will be helpful to gather information about the level at which the entity applies the business model assessment.

20. In the staff view, gathering further information on the frequency and circumstances in which reclassifications have occurred will help the Board in assessing whether the effects of the requirements are as expected, whether the requirements are working as

intended and whether the requirements are capable of being applied consistently. Therefore, the staff recommend the Board ask questions in the RFI on this matter.

Question 1 for Board members
Do you agree that regarding the **business model assessment** for financial assets, the Board should examine further in phase 2, and thus ask questions in the RFI, about: a. the application of judgement in applying the business model assessment; and b. reclassification of financial assets due to a change in business model?

B. Contractual cash flow characteristics assessment for financial assets

21. See section B of Agenda Paper 3A, and Agenda Paper 3B, for background and a summary of feedback on this topic.

Applying the contractual cash flow characteristics assessment in the light of market developments (including new product features)

22. Amortised cost is a simple measurement approach. The assessment to determine whether a financial asset has contractual cash flows that are solely payments of principal and interest (SPPI) helps entities to identify financial assets with contractual cash flows for which amortised cost provides useful information about the amount, timing and uncertainty of cash flows, and those for which fair value provides better information. Put simply, amortised cost is not an appropriate measurement basis for instruments with complex cash flows. If financial assets with cash flows other than payments of principal and interest (ie instruments that are not basic lending arrangements) were to be measured at amortised cost, users of financial statements would not receive useful information about the amount, timing and uncertainty of the cash flows.

23. The principles based SPPI assessment is designed so that entities can determine the appropriate measurement approach for any financial asset in the scope of IFRS 9 (ie the approach that provides users of financial statements with the most useful information). The staff agree with stakeholders that said that the PIR is a good

opportunity to assess how well the SPPI assessment has dealt with new product features and other market developments since IFRS 9 was issued. That is, we think it will be useful to assess whether:

(a) using the requirements in IFRS 9 entities can determine whether cash flows are SPPI or not, even if particular features or products did not exist when the Board developed the requirements; and

(b) the resulting measurement approach provides users of financial statements with useful information.

24. However, we also note that:

(a) the fact that new product features did not exist (and thus were not considered) when the Board developed the SPPI assessment does not necessarily mean that the Board needs to amend IFRS 9 to add specific application guidance for those product features. Rather, adding specific application guidance for new product features each time such features appear on the market risks moving away from a principles-based assessment and towards a rules-based assessment.

(b) examples and application guidance relating to particular financial assets may have been helpful to entities when they first began applying the SPPI assessment because that assessment was a new concept. In contrast, entities are now familiar with applying the SPPI assessment across a range of facts and circumstances and as such it is less likely that examples and specific application guidance are needed at this stage.

(c) the fact that a product feature becomes *common* does not mean that the product is necessarily a *basic* lending arrangement. In the staff view, whether a feature is common or uncommon is not relevant to determining the appropriate measurement approach.

25. By far, the most feedback in outreach related to applying the SPPI assessment to financial assets with interest rates linked to sustainability targets. Some stakeholders think the Board should urgently provide guidance on how the SPPI assessment should be applied to such financial assets. Given the amount of feedback received on this topic, and the questions raised by stakeholders, the staff have set out our preliminary

views on the relevant considerations when applying the SPPI assessment (see Agenda Paper 3B).

26. In the staff view, gathering further information on the application of the SPPI requirement, including application to new product features, will help the Board in assessing whether the requirements are working as intended (in particular, whether they provide useful information to users of financial statements, and whether the requirements are capable of being applied consistently and appropriately to new products). Therefore, the staff recommend the Board ask questions in the RFI on this matter. For example, we think it would be helpful to ask whether stakeholders think that there is sufficient application guidance in IFRS 9 to apply the SPPI assessment in the light of market developments (for example, to apply the assessment to financial assets with interest rates linked to sustainability targets as discussed in Agenda Paper 3B).

Investments in contractually linked instruments (tranches)

27. A structured investment vehicle may issue different tranches to create a 'waterfall' structure that priorities the payments by the issuer to the holders of different tranches. Paragraphs B4.1.20–B4.1.26 of IFRS 9 require that, unless impracticable, an entity 'look through' to assess the cash flow characteristics of the underlying pool of financial instruments and to assess the exposure to credit risk. As explained in paragraph BC4.33 of the Basis for Conclusions on IFRS 9, this requirement was added because the Board was persuaded that classification solely on the basis of the contractual features of the financial asset being assessed for classification would not capture the economic characteristics of the instrument when a concentration of credit risk arises through contractual linkage.

28. Feedback from outreach indicates there is a lack of clarity, and thus potential diversity in practice, relating to both the scope and the application of the requirements for CLIs. In the staff view, gathering further information on the circumstances in which entities are applying the CLI requirements or for which entities are unsure of whether the CLI requirements apply will help the Board in assessing whether the requirements are capable of being applied consistently. Therefore, the staff recommend the Board ask questions in the RFI on this matter. For example, we think it would be helpful to

gather further information on the fact patterns and analysis of examples of financial assets for which diversity in practice may exist, and to understand the effects of that diversity.

Question 2 for Board members
Do you agree that regarding the **contractual cash flow characteristics assessment** for financial assets, the Board should examine further in phase 2, and thus ask questions in the RFI, about: a. applying the assessment in the light of market developments (including new product features); and b. investments in contractually linked instruments?

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

29. See section C of Agenda Paper 3A for background and a summary of feedback on this topic.

30. This topic was a contentious issue during the development of IFRS 9 and as such the staff think it important that this topic be considered in the PIR. However, with regards to the feedback during outreach on recycling, the staff note that it is not the purpose of the PIR to redeliberate information the Board already considered when it developed the Standard. We think it will be important in the PIR for the Board to distinguish between:

    (a) information about the effects of the application of the requirements considering the changes compared to IAS 39 (ie new information); and

    (b) information that only repeats long-standing conceptual views that were discussed extensively by the Board and with stakeholders during the development of IFRS 9.

31. The staff view is that gathering further information about the effects of the application of the requirements will help the Board in assessing whether the requirements are working as intended. Therefore, the staff recommend the Board ask questions in the RFI on this matter. For example, we think it will be helpful to gather information on:

(a) how prevalent the use of the OCI presentation option for equity instruments is and what type of instruments it is used for; and

(b) how the OCI presentation option has affected entities' investment decisions (ie nature and types of investment) and the usefulness of information to users of financial statements.

32. As noted in Agenda Paper 3, we will continue to monitor academic research relevant to the PIR, including on this matter.

Question 3 for Board members
Do you agree that regarding the **option for equity instruments to present fair value changes in OCI,** the Board should examine further in phase 2, and thus ask questions in the RFI, about: a. the prevalence of use of the presentation option and types of instruments it is used for; and b. the effect of the option on entities' investment decisions and on the usefulness of information to users of financial statements?

D. Financial liabilities

33. See section D of Agenda Paper 3A for background and a summary of feedback on this topic.

34. As noted in Agenda Paper 3A, we did not receive a significant amount of feedback in this area during outreach. However, it is important that the Board take a holistic view of the requirements as a whole. As such, the staff think the Board should ask questions about the requirements for financial liabilities in the RFI.

35. The requirement to present changes in fair value due to changes in own credit risk in OCI applies for financial liabilities *designated* as at fair value through profit or loss (unless such treatment would create or enlarge an accounting mismatch in profit or loss). It does not apply to financial liabilities required to be measured at fair value through profit of loss.

36. As explained in paragraph BC5.35 of the Basis for Conclusions on IFRS 9, the requirement was added in response to long-standing and widespread concern from users of financial statements that over a long period of time changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

37. Some stakeholders in outreach suggested that separately identifying fair value changes due to changes in own credit can be challenging, and thus presenting such information might not be useful to users of financial statements. The staff note that the Board acknowledged this could be challenging in some circumstances when it developed the requirement. Paragraphs B5.7.16–B5.7.29 of IFRS 9 include application guidance on determining the effects of changes in credit risk.

38. Some stakeholders in outreach suggested that entities could (ie have the necessary ability and systems), and should be required to, present own credit changes in OCI for all financial liabilities classified as fair value through profit or loss. The staff note that during the development of IFRS 9 some stakeholders held opposing views on this matter.

39. In the staff view, gathering further information on the application of the own credit requirement will help the Board in assessing whether the requirements are working as intended (in particular, whether the requirements have resolved the issues they were designed to address and whether the resulting information is useful to users of financial statements). Therefore, the staff recommend the Board ask questions in the RFI on this matter.

Question 4 for Board members
Do you agree that regarding **financial liabilities designated at fair value through profit or loss**, the Board should examine further in phase 2, and thus ask questions in the RFI, about the presentation of changes in fair value due to changes in own credit risk in OCI?

E. Modifications to contractual cash flows

40. See section E of Agenda Paper 3A for background and a summary of feedback on this topic.

41. When working on Phase 2 of the IBOR reform project, the Board said it would consider the possibility of proposing a separate narrow-scope amendment to the requirements in IFRS 9 for modifications of financial assets and financial liabilities.

42. IFRS 9 does not describe what constitutes a 'modification' of a financial asset or financial liability. Paragraph 5.4.3 of IFRS 9 refers to the 'modification or renegotiation of the contractual cash flows' of a financial asset, while paragraph 3.3.4 of IFRS 9 refers to the 'modification of the terms' of an existing financial liability. The Board noted that although these paragraphs use slightly different words, both refer to a change in the contractual cash flows or contractual terms after the initial recognition of the financial instrument.

43. During Phase 2 of the IBOR reform project, the Board acknowledged that the lack of a description of what constitutes a 'modification' and the use of different wording in IFRS 9 to describe a modification of a financial asset or a financial liability could lead to diversity in practice when entities determine whether a change resulting from the reform should be treated as a modification applying the requirements in IFRS 9. At the time the Board noted that it may be helpful to entities if clarity was added to the requirements for modifications, however this would be outside the scope of the IBOR reform project.

44. Feedback from outreach in phase 1 of the PIR suggests that some stakeholders agree with the Board's previous comment that it may be helpful to add clarification for all modifications. However, other stakeholders expressed the view that practice has been dealing with the requirements well for a long time and as such no change is needed. The preliminary staff view is that the Board's consideration of whether or not to consider possible standard-setting in this area should depend upon whether there is diversity in practice and what is the effect of that diversity. Whilst we agree with some stakeholders the drafting could be improved, the Board would need to consider the cost and benefit of making a change to the drafting. Given that practice has been applying these requirements for many years, entities may have already overcome

obstacles to consistent application. Furthermore, even if some diversity in practice exists, the effect of that diversity may not be a significant detriment to the usefulness of information provided to users of financial statements.

45. In the staff view, gathering further information on how the modification requirements are being applied and whether stakeholders are aware of any diversity will help the Board in assessing whether the requirements are capable of being applied consistently. Therefore, the staff recommend the Board ask questions in the RFI on this matter. For example, we think it would be helpful to gather information on:

(a) how entities are assessing whether there has been a modification to the contractual cash flows of a financial asset; and

(b) circumstances for which entities are unsure, or diversity exists, in assessing whether a modification results in derecognition.

Question 5 for Board members
Do you agree that regarding **modifications to contractual cash flows,** the Board should examine further in phase 2, and thus ask questions in the RFI, about: a. the differences in drafting between the requirements for modifications for financial assets and financial liabilities; and b. determining when a modification results in derecognition?

F. Transition to IFRS 9

46. See section F of Agenda Paper 3B for background and a summary of feedback on this topic.

47. As noted in Agenda Paper 3B, we received little feedback in this area. However, whilst it is important that the PIR examine specific matters raised by stakeholders, it is also important that the Board take a holistic view of the requirements as a whole. In addition, feedback on the application of transition requirements can be useful input for developing transition requirements for future Standards.

48. Therefore, in the context of learning lessons for future standard-setting, the staff recommend the Board ask questions about the transition requirements in the RFI. For example, we think it would be helpful to gather information on:

(a) what challenges entities faced applying the classification and measurement requirements retrospectively and how they overcame those challenges;

(b) whether the combination of the relief from restating comparative information and the requirement for extensive transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements.

Question 6 for Board members
Do you agree that regarding the **transition requirements in IFRS 9,** the Board should examine further in phase 2, and thus ask questions in the RFI, about: a. the effects of transition reliefs provided; and b. the balance of reducing costs for preparers of financial statements and providing useful information to users of financial statements?