IFRS

STAFF PAPER

July 2022

IASB® meeting

Project	**Post-implementation review of IFRS 9—Classification and Measurement**
Paper topic	Modification of financial assets and financial liabilities and amortised cost measurement and the effective interest method – prioritising PIR findings

CONTACTS	Matthias Schueler	mschueler@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Purpose of this meeting

1. During this meeting the IASB has discussed the findings of the PIR presented in Agenda Paper 3A Modifications of financial assets and financial liabilities and Agenda Paper 3B Amortised cost measurement and the effective interest method.

2. Based on this paper, the IASB will be asked to decide whether and when to take further action to make those clarifications, applying its set criteria for addressing findings from post-implementation reviews (PIRs).

3. This paper provides:

   (a) a reminder of the IASB's two-step approach to addressing PIR findings;

   (b) the staff assessment of whether and when to take action in response to PIR feedback on the matters discussed in those agenda papers; and

   (c) the staff recommendation and question for IASB.

A reminder of the IASB's two-step approach to addressing PIR findings

4. At its June 2022 meeting, the Trustees of the IFRS Foundation considered the recent revisions to the description of PIRs in the *Due Process Handbook*.[1] These were previously discussed by the IASB in January 2022. In order to respond to findings identified in PIRs the IASB considers a two-step approach in deciding ***whether*** to take action and the ***prioritisation*** of any such action:

   (a) step 1—assess whether the findings from the PIR evidence that:

      (i) an objective of the new requirements is not being met;

      (ii) the benefits to users of financial statements of the information arising from applying the new requirements are significantly lower than expected (for example, there is significant diversity in application);or

      (iii) the costs of applying some or all of the new requirements and auditing and enforcing their application are significantly greater than expected (or there is a significant market development since the new requirements were issued for which it is costly to apply the new requirements consistently).

   (b) step 2—if the finding evidence any of those characteristics described in step 1 the timing of any action would depend on the prioritisation of the finding as high, medium or low, based on the extent to which evidence indicates:

      (i) the finding has substantial consequences;

      (ii) the finding is pervasive;

      (iii) the finding arises from a financial reporting issue that can be addressed by the IASB or the Interpretations Committee; and

      (iv) the benefits of any action would be expected to outweigh the costs. To determine this, the IASB would consider the extent of disruption and operational costs from change and the importance of the finding to users of financial statements.

5. Findings are addressed in accordance with their categorisation as follows:

[1] The description of PIRs in this paper has been aligned to this discussion. However, this description is subject to some final drafting improvements based on the discussion at the DPOC's June 2022 meeting.

(a) ***high priority findings***. Such findings are addressed as soon as possible. This category is expected to be used only rarely.

(b) ***medium priority findings***. Such findings are added to the IASB's research pipeline or the IFRS Interpretations Committee's pipeline.

(c) ***low priority findings***. Such findings are considered in the next agenda consultation and explored if identified as a priority.

(d) ***no action findings***. Such findings are not explored unless stakeholders identify the findings as a priority in their feedback on a future agenda consultation and the IASB decides, in its deliberations on the feedback, to take action.

Staff assessment of whether and when to take action in response to PIR feedback on particular aspects of amortised cost measurement

6. Since the topics of modification of financial assets and financial liabilities and the application of the effective interest method are interlinked and both relate to amortised cost measurement, we have grouped them together for the purpose of assessing the priority of the findings of the PIR.

   (a) **Modification of financial assets and financial liabilities—**how to apply the modification and derecognition requirements of IFRS 9.

   (b) **Application of the effective interest method—**how to reflect conditionality inherent in the contractual interest rate when determining the effective interest rate and the scope and interaction of paragraphs B5.4.5 and B5.4.6 of IFRS 9.

7. In the following tables we apply the IASB's two-step approach to help the IASB determine whether and when to take action on those topics.

Step 1—do the PIR findings evidence that further action should be taken?

8. The following table sets out each of the factors the IASB considers in assessing whether to take action in response to findings raised in a PIR, and the staff assessment of whether each of those factors is present in feedback on the IFRS 9 requirements for modifications of financial assets or financial liabilities and the application of the effective interest method:

Does PIR feedback indicate:	Staff assessment	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
(a) the objective of IFRS 9 is not being met?	**No** The objective of IFRS 9 with respect to modifications of financial assets and financial liabilities is to faithfully reflect the economic phenomenon of changing contractual terms thereby providing relevant information to the users. Some respondents have stated that the requirements for modification of financial assets or financial liabilities work as intended, but most	**No** The objective of IFRS 9 with respect to application of the effective interest method is to allocate interest over the relevant time period using the effective interest rate (EIR), thereby providing relevant information to the users. Some respondents have stated that the effective interest method works as intended, but most respondents also stated that further application guidance may be needed in specific cases of

Does PIR feedback indicate:	**Staff assessment**	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
	respondents also stated that further clarification and additional application guidance might be needed.	revisions to cash flows estimates for the purpose of the EIR calculation.
(b) the benefits to users of financial statements of the information arising from applying the new requirements are significantly lower than expected (for example, there is significant diversity in application)?	**Yes.** Respondents expressed concern about diversity in practice in assessing modifications of financial assets and financial liabilities as set out in Agenda Paper 3A for this meeting. Most respondents attributed the practice questions and difference in application to the fact that there is no underlying principle to determine when modifications of financial assets result in derecognition. Many respondents also said that the requirements for financial assets in paragraph 5.4.3 of IFRS 9	**Yes.** Respondents expressed concern about diversity in practice in applying the effective interest method for a floating rate financial instrument, in particular, if there is conditionality attached to the contractual interest rate as set out in Agenda Paper 3B for this meeting. Some respondents raised concerns about the number of different accounting policies developed by preparers and accepted by auditors which reduces the information comparability of financial information.

Does PIR feedback indicate:	**Staff assessment**	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
	are less specific than the comparable requirements for financial liabilities	
(c) the costs of applying some or all of the new requirements and auditing and enforcing their application are significantly greater than expected (or there is a significant market development since the new requirements were issued for which it is costly to apply the new requirements consistently)?	**Yes.** Feedback indicates that insufficient application guidance has resulted in significant application, audit and enforcement challenges. This was also evident through the responses to the IFRS Interpretation Committee Agenda Decisions.	

9. In the staff view, most of the characteristics described in step 1 are present in the findings. Therefore, the staff recommend that the IASB considers taking further actions for the findings identified. We have also provided our views in each of the separate papers on why we think standard-setting might be needed.

Step 2—is the finding high, medium or low priority?

10. The following table sets out each of the factors the IASB considers in assessing the priority for taking an action in response to findings raised in a PIR, and the staff assessment of the priority that should be assigned to possible action in response to the findings identified:

Does PIR feedback indicate:	**Staff assessment**	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
(a) the finding has substantial consequences?	**Yes.** Respondents indicated that uncertainty about how to apply the requirements for modification of financial assets and financial liabilities and revisions of contractual cash flows of financial instruments already result in diversity in practice. This divergence would not provide useful information to users of financial statements.	
(b) the finding is pervasive?	**Yes.**	

Does PIR feedback indicate:	Staff assessment	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
	As the requirements of both topics were carried over at the adoption of IFRS 9, application questions on these requirements have been raised, either to the IFRS Interpretations Committee or the IASB for a long time including before IFRS 9 became effective. Considering the long history of application question there is clear evidence that the findings concerning both topics are pervasive.	
(c) the finding arises from a financial reporting issue that can be addressed by the IASB or the Interpretations Committee?	**Yes.** We think the findings could be addressed by the IASB. The staff view is that a clarification of the definition of modifications of financial assets and financial liabilities will resolve many of the application question raised by stakeholders throughout the PIR process. The application questions raised pre-dates the IFRS 9 effective date and the IFRS Interpretation Committee have tried several times but were unable to resolve these questions due to a lack of	**Yes.** We think the findings could be addressed by the IASB. PIR feedback raises many application questions on the scope of paragraph B5.4.5 of IFRS 9. The need to clarify the scope can only be achieved by standard-setting, rather than interpretation or educational material. The application questions raised pre-dates the IFRS 9 effective date and the IFRS Interpretation Committee have tried several times but were unable to resolve these questions due to a lack of

Does PIR feedback indicate:	**Staff assessment**	
	Modification of financial assets or financial liabilities	**Application of the effective interest method**
	sufficient application guidance in IFRS 9 (and previously IAS 39).	sufficient application guidance in IFRS 9 (and previously IAS 39).
(d) the benefits of any action would be expected to outweigh the costs? To determine this, the IASB would consider the extent of disruption and operational costs from change and the importance of the finding to users of financial statements.	**Yes.** The staff view is that any action would focus only on clarifying the requirements and providing additional application guidance as set out in the separate agenda papers for this meeting, while at the same time being principle-based and generally applicable.	

Conclusion

11. Based on the analysis in this paper, the staff recommend the IASB to categorise findings related to clarifying the requirements of IFRS 9 in relation to modification financial assets and financial liabilities and the application of the effective interest method as <u>medium</u> priority.

12. While staff is of the opinion that the number of application questions raised on these topics warrants standard setting, we are at the same time aware that any potential change to IFRS 9 might, to some extent, disrupt existing practice and involve costs for preparers to implement and would require careful consideration.

13. For that reason, we believe that clarifying the requirements as discussed in Agenda papers 3A and 3B for this meeting, would:

    (c) maximise the benefits of going through the standard-setting process with relatively small incremental effort; and

    (d) minimise the risk of any unintended consequences or impacts that could result from making one amendment in advance of another amendment in the same area of the requirements (ie consider the modifications requirements together with the requirements on the effective interest method).

14. We also acknowledge the potential interaction between the application questions on modifications and amortised cost measurement, and the expected credit loss requirements in IFRS 9. We therefore think that any decision on starting a standard-setting project needs to consider any potential findings of the PIR of IFRS 9—Impairment requirements.

Staff recommendation and question for the IASB

15. Based on the analysis in this paper, the staff recommend the IASB adds a project to its research pipeline to explore potential clarification of the requirements for assessing modification of financial assets and financial liabilities and the application of the effective interest method.

Question for IASB
Do you agree with the staff recommendation to add a project to the IASB's research pipeline to clarify particular aspects of the IFRS 9 requirements for the application of the effective interest method and modifications of financial assets and financial liabilities?