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Post-implementation Review of IFRS 9 – Classification and Measurement
Cover Note

Objective

1 The objective of the session is to:

(a) Update the EFRAG FR TEG-CFSS on the current status of the IASB discussion on the post-implementation review of IFRS 9 – Classification and Measurement.

(b) **Obtain feedback from EFRAG TEG-CFSS members on questions the IASB will raise at the July 2022 ASAF meeting** regarding the possibility of making a narrow-scope amendments to IFRS 9 requirements relating to the cash flow characteristics of financial assets and the discussion on prominence of other issues raised during the post-implementation review.

2 Due to the time constraint focus will be on the questions to the ASAF meeting please see paragraphs 24 to 26, 33, 36, 39, 42 and 45.

Background of the IASB project

3 In October 2020, the IASB decided to begin the PIR of the IFRS 9 classification and measurement requirements. The Request of Information on IFRS 9 was published on 30 of September 2021 with comments to be provided by 14 January 2022.

4 In its March and April 2022 meeting IASB discussed a summary of the feedback received on its consultation and a plan for the next phase of the project. The IASB members did not make any decisions but provided their views on the feedback received.

5 The IASB members welcomed the feedback that in general the classification and measurement principles of IFRS 9 worked well in practice and result in measurement of financial instruments that provides useful information to users of financial statements about amount, timing and uncertainty of an entity's future cash flows.

6 The majority of specific feedback related to two topics:

(a) ESG-linked features – how to assess whether a financial asset has SPPI cash flows when the instrument has ESG-linked features; and

(b) contractually linked instruments (CLIs) – the scope of transactions to which the contractually linked instruments requirements apply and how to apply those requirements.

7 The IASB also considered six application questions raised in the feedback:

(a) Question A – whether a financial asset has non-recourse features (i.e., features that limit an entity's claim to specified assets of the debtor), and under what circumstances an entity is required to assess the cash flows from the specified assets;

(b) Question B – whether an entity needs to consider cash flows arising from bail in legislation when the relevant legal requirements are reproduced or referred to in a contract;

(c) Question C – whether interest rates that are contractually adjusted for inflation introduce leverage;

(d) Question D – whether interest rates that include a government-imposed leverage factor are regulated interest rates as described in IFRS 9;

(e) Question E – whether a prepayment feature includes reasonable compensation for early termination of a contract; and

(f) Question F – whether particular types of interest rates include a modified time value of money element.

8 The IASB decided to:

(a) consider Question A with its analysis of contractually linked instruments;

(b) consider Question B after its Financial Instruments with Characteristics of Equity project has developed further;

(c) perform outreach with members of ASAF and the IFRS IC to gather further information about Question C and Question D; and

(d) take no further action on Question E and Question F.

Financial assets with ESG-linked features and contractually linked instruments (CLIs)

9 In the meeting of April 2022, the IASB analysed feedback on the requirements for assessing a financial asset's contractual cash flow characteristics. The IASB discussed the two main topics raised in the feedback – contractually linked instruments and financial assets with ESG-linked features.

10 With regards to what potential clarifications could be made in regard financial assets with ESG-linked features, the IASB staff believed the IASB could consider:

(a) adding application guidance with respect to the characteristics of a basic lending arrangement and its link to amortised cost measurement. In their view, such additional application guidance would not only assist entities with assessing the contractual cash flows of financial assets with ESG-linked features, but would also help more consistent application of the SPPI assessment in general;

(b) clarifying how to assess whether variability arising from contractual terms that change the timing or amount of contractual cash flows are consistent with SPPI; and

(c) considering how the disclosure objectives and principles in IFRS 7 would apply to financial assets with ESG-linked features, including information about an entity's exposure to risks arising from such features and how an entity manages such risks.

11 With regards to what potential clarifications could be made in regard contractually linked instruments, the IASB staff believed the IASB could consider clarifying:

(a) the key characteristics of a CLI to clarify for what types of contractual arrangements the requirements were intended (scope). The IASB staff considered that such clarification will help ensure that the relevant requirements are applied consistently and that the resulting classification outcomes will faithfully represent the underlying economics and substance of the financial instruments;

(b) the cash flow characteristics of instruments in the underlying pool for a CLI to meet the SPPI requirements. The IASB staff noted that even if the IASB amended IFRS 9 to scope out the most senior tranche from the CLI requirements, IFRS 9 would still require the holder to assess the effects of the cash flows of the underlying pool of instruments. Scoping out the most senior tranche from the CLI requirements would not necessarily alleviate the need to consider the effect of the cash flows of the underlying pool on the senior tranche.

12 In the meeting of May 2022, the IASB tentatively decided to start a standard – setting project to clarify particular aspects of the requirements for assessing a financial asset's contractual cash flow characteristics.

13 The purpose of the project would be to make drafting changes and additions, and possibly add examples, to support entities to consistently assess the contractual cash flow characteristics of all financial assets. Areas that the PIR has indicated would benefit from clarification are:

(a) assessing contractual terms that change the timing or amount of contractual cash flows (paragraphs B4.1.10−18 of IFRS 9), in particular:

(i) clarifying whether and when the nature of a contingent event (i.e., the trigger for a change in contractual cash flows) is or is not relevant to determining whether the cash flows are SPPI applying paragraph B4.1.10 of IFRS 9 (for example, considering an interest-rate incentive that is triggered by the borrower meeting pre-defined ESG targets);

(ii) assessing whether a financial asset might represent an investment in a particular asset applying paragraphs B4.1.16−B4.1.17 of IFRS 9 even if the contractual cash flows are described as payments of principal and interest (for example, considering financial assets with non-recourse features); and

(b) assessing whether an instrument is in the scope of the requirements for CLIs (paragraphs B4.1.20−B4.1.26 of IFRS 9).

14 The IASB has agreed to the following indicative timetable:

Topics for discussion	Timing 2022	Decisions
1. Contractual cash flow characteristics		
a. General	April	Decided actions on 6 application questions (4 actions, 2 no actions)
b. ESG-linked features	April–May	Decided to start project to clarify aspects of SPPI requirements
c. Contractually linked instruments		
2. Equity instruments and OCI	**June**	**Initial staff analysis on feedback and potential actions**
3. Equity instruments and OCI	July	Prioritisation of any potential further actions
4. Modifications to contractual cash flows	Q3	
5. Amortised cost and the effective interest rate method	Q3	
6. Business model assessment	Q3	
7. Other matters	Q3	

Project plan for amendments to IFRS 9 Contractual Cash Flow Characteristics of Financial Instruments

Proposed project objective

15 The IASB Staff think that it is unnecessary to create an exception from the SPPI requirements for financial assets with ESG-linked features. The IASB Staff think adding more explanations of the overall objective of the SPPI requirements and providing additional application guidance through standard-setting will address the issue effectively and efficiently. The IASB Staff is of the view that many of the questions around the application of the CLI requirements are symptomatic of the lack of understanding of the scope of instruments to which the requirements apply. The IASB Staff think that most of these questions could be resolved by providing a clear description of CLIs and the requirements applicable to the underlying pool of instruments.

16 The proposed objective of this project would therefore be to make clarifying amendments to the application guidance in paragraphs B4.1.7 to B4.1.26 of IFRS 9 to enable the consistent application of the SPPI requirements and to consider whether additional disclosure requirements are needed.

Proposed project scope

17 The IASB Staff's view is that objective for this project will be best achieved by clarifying the following aspects of the SPPI application guidance:

(a) the concept of a basic lending arrangement (paragraph B4.1.7A);

(b) whether and how the nature of a contingent event (ie the trigger for a change in the timing or amount of contractual cash flows) is relevant to determining whether the cash flows are SPPI (paragraphs B4.1.10 and B4.1.11);

(c) examples in paragraphs B4.1.13 and B4.1.14 of applying the SPPI requirements to specific fact patterns (including adding additional examples for financial assets with ESG-linked features);

(d) the meaning and characteristics of non-recourse features (including rearticulation of the need to assess the underlying assets or cash flows);

(e) the meaning and scope of instruments to which the CLI requirements are applied (paragraph B4.1.20); and

(f) the requirements for the underlying pool of instruments for a CLI to meet the SPPI requirements (paragraphs B4.1.23 and B4.1.25).

18 The IASB Staff also propose assessing whether additional disclosure requirements are needed regarding contractual terms that could affect the amount or timing of contractual cash flows.

19 At this stage, the IASB Staff do not expect the project to clarify or amend other areas of IFRS 9, including:

(a) the underlying principles of classifying financial assets (paragraphs 4.1.1 to 4.1.5);

(b) subsequent measurement of financial assets measured at amortised cost and applying the effective interest rate method (paragraphs 5.4.1 to 5.4.2 and B5.4.1 to B.5.4.7);

(c) the requirements for classifying financial liabilities (paragraphs 4.2.1 to 4.2.2);

(d) the requirements related to embedded derivatives (paragraphs 4.3.1 to 4.3.7); and

(e) any other aspects of the SPPI requirements, including considerations around the modified time value of money and probability of contingent events.

<u>High-level project timing</u>

20 The table below summarises the indicative timing and key areas for discussion that will require decisions from the IASB at future meetings.

Preliminary timeline	**Topics for discussion / Publication**
Q3 2022	Consideration of potential clarifications
Q4 2022	Consideration of potential clarifications (continued) Permission to ballot
Q1 2023	Publication of Exposure Draft

21 The proposed clarifications for non-recourse features and CLIs are not high priority matters, but there is an interaction with the general SPPI requirements. The IASB Staff do not think it would be appropriate for the potential clarifications to the general SPPI requirements to be unduly delayed if there is an indication that the proposed clarifications for CLIs (as listed in paragraph 8(e) and (f)) would require more extensive analysis. If this would appear to be the case, the IASB Staff will prioritise the work on the general SPPI requirements to ensure the publication of the exposure draft is not delayed beyond Q1 2023

22 In June 2022 meeting, the IASB discussed the project plan for Amendments to IFRS 9 Contractual Cash Flow Characteristics of Financial Assets (Agenda Paper 16). The IASB was not asked for any decisions.

23 IASB members were overall supportive to the scope and direction of the project proposed by IASB Staff, and the indicative timeline.

Questions for EFRAG FR TEG-CFSS members (ASAF questions)

24 Do you consider that the proposed clarifying amendments would address the common application challenges with regards to:

(a) financial assets with ESG-linked features; and

(b) contractually linked assets?

25 Do you have any recommendations for clarifying the concept of a "basic lending arrangement"?

26 Do you have any other comments on the IASB standard-setting project?

Other issues raised during the post-implementation review

27 At its January 2022 meeting, the IASB discussed a two-step approach to deciding whether and when to take further action in response to findings identified in PIRs.

28 The first step of the approach is related to assess whether the findings from the PIR evidence that: (i) the new requirements is not being met; (ii) there is a significant deficiency in how information arising from application of the new requirement; or (iii) the costs are significantly greater than expected.

29 If the findings evidence any of those characteristics described in the previous paragraph, the IASB will prioritise the issues based on the extent to with evidence indicates (among other things):

(a) the matter has substantial consequences;

(b) the finding is pervasive.

30 With reference to these two specific indicators, the IASB is seeking feedback on the prominence of the following issues raised during the post-implementation review in ASAF members' jurisdictions.

Issue 1 – Contractual cash flow characteristics – Contractual inflation adjustments and leverage

31 Paragraph B4.1.9 of IFRS 9 explains: "*… Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest... Thus, such contracts do not [have SPPI cash flows] and cannot be subsequently measured at amortised cost or fair value through other comprehensive income*".

32 In some jurisdictions, it is common for the interest rate of financial instruments to be contractually linked to an index that adjusts the time value of the money based on a market interest rate and / or inflation rate. Some PIR respondents expressed the view that linking principal and interest payments to such an index result in a 'current level' time value or money (i.e., the 'real' interest rate). PIR respondents therefore questioned whether such adjustments introduce leverage in the context of recent significant rises in inflation rates.

Questions for EFRAG FR TEG-CFSS members

33 Are financial instruments with contractual inflation-adjustments creating potential leverage widespread in your jurisdiction?

Issue 2 – Contractual cash flow characteristics – Regulated interest rates and leverage

34 Paragraph B4.1.9E of IFRS 9 explains: "*… a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of [assessing whether cash flows are SPPI] if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement*".

35 In some jurisdictions, financial instruments with regulated interest rates can include a leverage factor imposed by the government. For example, the interest rate on a loan is determined based on a factor of say 1.3 times the government bond yield at disbursement plus a spread. PIR respondents asked whether such interest rates are regulated rates applying paragraph B4.1.9E of IFRS 9, and if it is, how to consider whether the rate provides exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement applying paragraph B4.1.9E of IFRS 9.

Questions for EFRAG FR TEG-CFSS members

36 Are financial instruments with similar leverage factors imposed by government/regulators widespread in your jurisdiction?

Issue 3 – Derecognition – Assessing whether a financial asset is derecognised

37 When an entity transfers a financial asset, paragraph 3.2.6 of IFRS 9 requires the entity to determine whether:

(a) substantially all risks and rewards have been transferred (derecognise asset);

(b) substantially all risks and rewards have been retained (continue to recognise asset); or

(c) if neither substantially all the risks and rewards have been retained or transferred, whether the entity has:

  (i) transferred control of the financial asset (derecognise asset); or

  (ii) retained control of the financial asset (continue to recognise asset to the extent of continuing involvement).

38 A few PIR respondents said that it is not clear how to apply the derecognition requirements in paragraph 3.2.6 of IFRS 9, especially in the context of assessing whether the entity has:

(a) retained control when a financial asset is transferred to a special purpose vehicle or in the case of a securities lending arrangement;

(b) continuing involvement, for example when servicing the transferred asset, providing recourse or pledging collateral, and how to account for such continuing involvement.

Questions for EFRAG FR TEG-CFSS members

39 Are you aware of any widespread diversity in practice with a material effect in how these derecognition requirements are applied?

Issue 4 – Scope – Contracts to buy or sell a non-financial item

40 Paragraph 2.4 of IFRS 9 explains: "*[IFRS 9] shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument … [including when] the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments except for contracts entered into and held … in accordance with the entity's expected purchase, sale or usage requirements (i.e., own use)*".

41 A few PIR respondents said that there is diversity in practice in applying these requirements, in particular:

(a) what constitutes 'similar' contracts or what amounts to 'practice' of net cash settlement;

(b) whether, and if so when, an entity is permitted to change its accounting for such contracts if there is a change in management's intention for the contract.

Questions for EFRAG FR TEG-CFSS members

42 Are you aware of any widespread diversity in practice with a material effect when applying the 'own use' exemption?

Issue 5 – Equity investments and OCI – accounting for transaction costs

43 Paragraph 5.7.1(b) of IFRS 9 explains: "*A gain or loss on a financial asset that is measured at fair value shall be measured in profit or loss unless it is an equity instrument on which the entity has elected to present gains and losses other comprehensive income*".

44 A few PIR respondents said that due to insufficient guidance, there is a diversity in practice in the accounting for transaction costs in the disposal of equity instruments for which the entity has elected to present gains and losses in other comprehensive income, with some entities recognising these costs in profit or loss and others recognising the costs in other comprehensive income.

Questions for EFRAG FR TEG-CFSS members

45 Are you aware of any widespread diversity in practice with a material effect with regards to the accounting for transaction costs on these instruments?

<u>Equity instruments and other comprehensive income</u>

46 In the initial discussion on feedback received on equity instruments and other comprehensive income (OCI) the IASB Staff presents preliminary views on the following topics:

(a) On the consistent application of the OCI election the IASB staff presented an understanding for a need to clarify the scope of the equity instruments to which the OCI presentation election can be applied;

(b) On the request to broaden the scope of the OCI presentation election the IASB Staff is of the view that the requests for OCI recycling should not be categorised as requests to amend the current OCI presentation election in IFRS 9. Rather, those requests are asking for a new classification category for equity instruments that they think would better reflect a long-term business model or strategy. This would be a significant change to the classification approach in IFRS 9, rather than being only an adaption of the OCI presentation election;

(c) On the request to amending IFRS 9 to add a new classification category for equity instruments election the IASB Staff is of the view that this would add complexity and would only be justified if there is evidence that there is a significant deficiency in the information that investors are being provided. The IASB Staff indicate that they do not think that this is the case; and

(d) On the request open the OCI presentation election to "equity-like" instruments the IASB Staff is of the view that it would not be appropriate to extend the OCI presentation option to "equity-like" instruments that do not meet the definition of an equity instrument in IAS 32.

47 During its June 2022 meeting, the IABS board had an initial discussion on feedback received on equity instruments and OCI and received the IASB Staff preliminary views (reported on the Agenda Paper 3A). The IASB was not asked for any decisions.

48 IASB members were overall supportive to the IASB Staff preliminary views and welcomed the feedback that in general the option to present FV changes on investments in equity instruments in OCI works as the IASB intended.

49 Several IASB members noted that reintroduce the recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. If recycling will be permitted or required, a robust impairment model would be needed, which would add complexity and be difficult to develop.

50 Some IASB member considered that the feedback provided by stakeholders highlighted that the scope for the OCI presentation election that the IASB had in mind when the Standard was published is not applied consistently. Particular considerations should be discussed in relation to the insurance companies and the connection with the IFRS 17 requirements.

51 One IASB member noted that a possible way forward could be to clarify in the Standard the scope of the OCI presentation election by referring to the indications describe on the Basis of Conclusions of IFRS 9.

52 Another IASB member considered valuable to expand the perimeters of the OCI presentation election to include a narrow scope of puttable instruments and funds that invest in equity instruments. It was noted that, from the holder perspective, these types of instruments have equity risks, and it seems to be reasonable to consider them in the scope of the OCI presentation election.

53 Some IASB members asked IASB Staff to conduct further analyses on information users' needs and how to improve consistently the impairment test.

54 One IASB member was in favour of further discussion on the potential inconsistency in IFRS 9 between the requirements in paragraph B5.1.2.A (day 1 gain or loss) and the requirements in paragraph 5.7.1 for the presentation of fair value changes. It was also noted that in practice there are several issues regarding the estimation of

the fair value of unquoted instruments, therefore the reintroduction of the IAS 39 exemption to fair value measurement could be reconsidered.

Next steps

55 The EFRAG Secretariat will continue to monitor the IASB discussions.

Agenda Papers

56 In addition to this cover note, agenda paper 09-02 – *ASAF Paper AP3 PIR IFRS 9 CM* – has been provided for the session.