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Post Implementation Review of IFRS 9 - Summary and analysis of the comment letters received

1 Based on the comments received, the EFRAG Secretariat has developed a revised draft EFRAG final comment letter that is presented as agenda papers 02-06 (clean) and 02-07 (compared).

Structure of the paper

2 This comment letter analysis contains:

(a) Background;

(b) Summary of constituents;

(c) Summary of constituents' views;

(d) Appendix 1 - detailed analysis of responses to questions in EFRAG's draft comment letter, the EFRAG Secretariat's recommendations and questions to EFRAG TEG; and

(e) Appendix 2 – list of constituents.

Background

3 EFRAG published a draft comment letter (DCL) on the IASB proposals on 8 November 2021. In the DCL, EFRAG notes several issues that are prevalent in Europe and might deserve standard-setting activities. Those with highest priorities are the application of the SPPI-test to sustainable finance products, the absence of recycling for FVOCI equity instruments, the treatment of equity-type instruments and reporting on reverse factoring.

4 During the consultation period the EFRAG Secretariat consulted the EFRAG FIWG, EFRAG IAWG and EFRAG User Panel and held several one-to-one meetings with constituents to get more detailed information on financial instruments with ESG features and equity-type instruments. The main messages from EFRAG FIWG, EFRAG IAWG and EFRAG User Panel are presented in paper 02-03. The main messages from the one-to-one meetings with constituents are presented in paper 02-04.

Summary of constituents

5 At the time of writing, 13 comment letters and two drafts have been received. The letters are summarised below by type of constituent.

Summary of constituents' views

Prioritisation of issues (Cover Letter)

6 The constituents who answered this question either agreed or generally agreed with the prioritisation of the issues identified by EFRAG.

7 Three constituents (two preparer organisations and one preparer) questioned:

(a) the high and medium priorities assigned to supply chain financing and factoring of trade receivables; and

(b) whether administrative rates and modification required standard-setting.

8 Two preparer organisations from the banking industry suggested to add the following issues as requiring standard-setting activity:

(a) the loan syndications;

(b) accounting for purchased or originated credit impaired financial assets (POCI); and

(c) practical guidance on how to implement the current requirements of hedge accounting to insurance business of financial conglomerates.

9 Two constituents (preparer and preparer organisation from insurance industry), although acknowledging the increasing importance of the ESG issue, suggested to enhance the current IFRS 9 rules with specific classification guidance for these types of investments but abstain from fundamental changes to the overall SPPI concept.

Classification and measurement

10 EFRAG received nine responses to this question.

11 Majority of constituents (user organisation, four national standard setters and two preparer organisations from insurance industry) agreed that the classification and measurement requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how an entity expects to manage them.

12 The constituents, nevertheless, highlighted the following issues:

(a) significant burden to prove that banking book passed the SPPI test in the stressed market situations;

(b) current IFRS 9 measurement rules for equity and equity-type financial instruments do not always adequately reflect the holders' applicable business model under which an investment in an equity instrument is held (long-term holding versus trading purpose) and use FVTPL as an anchor point. This issue is particularly relevant for insurance entities;

(c) inability to account for equity instruments and investments in puttable instruments at FVOCI with recycling when they do not pass the SPPI test, although they meet the business model condition; and

(d) application of the SPPI cash flow criterion to financial instruments whose contractual cash flows are linked to ESG target achievements may be challenging.

13 Many constituents (user organisation, preparer organisation from the insurance industry and four national standard setters) agreed that on overall classification and measurement requirements of IFRS 9 based on the business model provide information that is useful for users to assess the amounts and timing of future cash flows.

14 Two constituents (user organisation and national standard setter) indicated their preference for amortised cost accounting when assessing a financial institution's banking book.

15 One constituent (national standard setter) shared practical concerns on applying SPPI test and business model requirements on implementation to IFRS 9 highlighted by stakeholders in its jurisdiction.

16 One constituent (national standard setter) mentioned that in certain areas, such as reclassification, the IFRS 9 requirements do not always result in useful information for the users of financial statements.

Business model for managing financial assets

17 Six constituents (one user organisation, one national standard setter, one preparer-insurer and three preparer organisations from the insurance and banking industry) agreed that no further standard-setting activities should be contemplated as there is sufficient guidance to conduct a consistent and sustainable business model assessment.

18 However, one national standard setter noted that the IASB should undertake standard setting to consider permitting reclassifications in circumstances other than those specified in paragraph B4.4.1 of IFRS 9.

19 One constituent (preparer organisation) noted that there was not any diversity in practice and did not experience unexpected effects from the business model assessment.

Contractual cash flow characteristics

20 Five constituents (two preparer organisations from the insurance and banking industry, one preparer-insurer, two national standard setters) agreed that the cash flow characteristics assessment is working as the IASB intended. Four constituents (one user organisation, one preparer organisation-insurer, two national standard setters) added that it (generally) leads to useful information.

21 Thirteen constituents (user organisation, four national standard setters, six preparer organisations from the insurance and banking industry, two preparers-insurer-bank) noted that issues arise for financial instruments with ESG features.

22 Constituents further provided examples of financial instruments where the cash flow characteristics assessment does not lead to useful information or require further standard-setting activities.

Equity instruments and other comprehensive income

23 Eleven constituents (six national standard setters, one preparer-insurer and four preparer organisations from the insurance and banking industry) agreed that the absence of recycling creates significant constituents' concerns.

24 Three constituents (two national standard setters and one preparer organisation from the banking industry) emphasized that the need for recycling of equity instrument will increase when IFRS 17 is implemented.

25 Four constituents (three preparer organisations and one preparer) suggested including rebuttable quantitative impairment triggers in an impairment model for FVOCI:

(a) if either its current fair value is more than 20% below the acquisition cost or its current far value has remained below the acquisition cost for more than the last 9 consecutive months; or

(b) if either its current fair value is more than 25% below the acquisition cost or its current far value has remained below the acquisition cost for more than the last 6 consecutive months.

26 Eight constituents (four national standard setters, one preparer-bank and three preparer organisations from the insurance and banking industry) agreed that similar fact patterns should be treated similarly.

27 Seven constituents (four preparer organisations from the banking and insurance industry and two preparers-bank-insurers) believed that classifying puttable instruments as debt from the perspective of the issuer also depicted a misleading view because the put option had no intrinsic value as the put option was merely there to provide liquidity to the investor. They proposed that '*equity-type instruments could encompass any form of financial instrument that entitles the holder to a return based on the net assets of the fund*'.

28 Two preparer organisations from the insurance and banking industry highlighted insurers invested in equities indirectly, for example through investment funds. Therefore, to provide relevant information for the performance of long-term investors, the accounting treatment of equity-type instruments should be extended to instruments such as UCITS.

Financial liabilities and own credit

29 EFRAG received eight responses to this question.

30 Many constituents (user organisation, two national standard setters, two preparer organisations from the insurance and banking industry and one preparer-insurer) agreed that the requirements for presenting the effects of own credit risk in OCI are working as intended.

31 One constituent (national standard setter) highlighted the significant judgement involved in measuring own credit spread and auditing the calculations. Therefore, it might be difficult for users of financial statements to understand the rationale underlying the effects of own credit risk presented in OCI.

32 Another constituent (preparers organisation from insurance industry) highlighted that for contracts within the fair value option, that contain one or more embedded derivatives to be separated that cannot be measured reliably, it might be difficult to present the effects of own credit risk in OCI, as the components of the instrument are closely linked and cannot be isolated easily. This constituent suggested to consider allowing an option to measure the whole instrument at FVTPL in such circumstances.

Modifications to contractual cash flows

33 Two constituents (one preparer organisation from the insurance industry and one preparer-insurer) mentioned that the requirements for modifications work as intended. Moreover, they supported a narrow scope amendment to introduce consistent wording for the description of a modification of a financial asset and a financial liability in order to clarify the requirements for modifications.

34 Two constituents (one national standard setter and one preparer organisation from the banking industry) mentioned that the requirements for modifications did not work as intended on:

(a) requirements of IFRS 9 5.4.2 for financial assets; and

(b) restructuring of loans.

35 Three constituents (two national standard setter and one preparer organisation from the banking industry) agreed that the absence of a definition of "substantial modification" and of derecognition thresholds for financial assets in IFRS 9, has led to some diversity in practice. However, they noted that practice has now been established by preparers and no further guidance is needed.

Amortised cost and the effective interest method

36 Four constituents (two preparer organisations from the insurance industry, one preparer-insurer, one national standard setter) believed the effective interest method is working as the IASB intended (and can be applied consistently). One user organisation noted that the effective interest rate method provides useful information for users.

37 One national standard setter noted that the effective interest method cannot be entirely applied consistently and provided examples thereof. Also, one preparer organisation provided examples of when estimating the EIR is challenging.

38 One national standard setter noted that only standard setting could achieve clarity in how to calculate the EIR for a TLTRO III tranche on initial recognition and added recommendations to the IASB for dealing with modifications of cash flows.

Transition

39 One constituent national standard setter reported that the transition requirements work well and that one unexpected issue they observed was that upon transition some banks reset the OCI movement of FVOCI portfolios to zero. Constituents from the insurance industry and one banking industry association expressed appreciation for the recent IASB Amendments on IFRS 17 and IFRS 9 Comparatives.

40 One constituent (preparer organisation-banking industry) questioned the usefulness of the continued transition disclosures, specifically referring to the need to disclose what the fair value of assets would have been which have been transferred to amortised cost and which were previously measured at fair value for that specific portfolio at the moment of transition.

Other matters

41 One preparer organisation from the insurance industry asked to align the option on treating financial guarantees on the issuers' side also to the holders' side. Another preparer organisation from the banking industry noted that the possibility for an issuer to treat a financial guarantee contract as an insurance contract should not be changed.

42 Two constituents – one individual, one national standard setter – requested to adapt the accounting treatment of respectively, Virtual Power Purchase Agreements and oversized contracts (both related to energy delivery). The national standard setter further recommended standard setting for TLTRO III loans (please refer to paragraph 38).

Questions to EFRAG Board and TEG

43 Do EFRAG Board and TEG have comments on the inputs received?

Appendix 1 - Detailed analysis of responses to questions in EFRAG's draft comment letter

Cover letter - Questions to constituents

> The issues of sustainable finance-SPPI test, recycling changes in FV accumulated in OCI for equity instruments, treatment of equity-type instruments and supply chain financing are indicated as high priorities. Modification of cash flows, contractually linked instruments - non-recourse, factoring of trade receivables and use of administrative rates are indicated as medium priorities. Finally, financial guarantees are indicated as a low priority. Do you agree with the issues raised and their prioritisation as indicated above? Please explain.
>
> Do you consider that there are other issues that deserve standard-setting activities? Please provide an illustration.

Summary of constituents' comments

44 Two constituents (national standard setters) agreed with the outlined priorities of the nine issues addressed by EFRAG in the DCL.

45 Three constituents (two preparer organisations and one preparer-bank) although they generally agreed with the prioritisation of issues raised, disagreed with:

(a) high and medium priority assigned to supply chain financing and factoring of trade receivables respectively. In one constituent's view IFRS 9 has not substantially changed anything in this regard and the accounting practice was established (preparer organisation);

(b) supply chain financing being a priority issue (preparer organisation); and

(c) administrative rates and modification being candidates for standard-setting (preparer).

46 Two constituents (preparer organisations from the banking industry) suggested to add the following issues as requiring standard-setting activity:

(a) The loan syndications - if the entity decides to ultimately retain the unsold portion, amortised cost would provide more useful information.

(b) Accounting for purchased or originated credit impaired financial assets (POCI) – the issue is linked to restructured loans whereby there is an unclear distinction between derecognition and modification. Economically, there is often no difference, but accounting is very different. In addition, in case a POCI cures, it generates a negative ECL, which is conceptually strange. Finally, POCI accounting causes the loss at start date of the original loan, which disturbs the follow-up of the customer's performance.

(c) Urgent need for practical guidance on how to implement the current requirements of hedge accounting to insurance business of financial conglomerates, considering that the measurement requirements in IFRS 9 do not take into consideration any exceptions for derivatives exclusively entered into and held to manage the interest rate risk in the insurance business (e.g., asset swaps or IRS that support the long-term interest rate guarantees provided to policyholders). In other words, how the existing practice for hedging strategies in the banking sector can be extended and applied to the insurance sector. In this constituent's view there is not enough guidance for entities that may want to set a hedging relationship between an asset swap and the net cash flows resulting from their combined investment portfolio and insurance contracts liabilities when these are measured under the general model in IFRS 17.

47 Two constituents (preparer and preparer organisation from insurance industry) although agreeing with the increasing importance of the ESG issue, suggested to enhance the current IFRS 9 rules with specific classification guidance for these types of investments but abstain from fundamental changes to the overall SPPI concept of IFRS 9.

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the nature, timing and uncertainty of future cash flows?

Why or why not?

Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing or using information about financial instruments.

This question aims to help the Board understand constituents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

Proposals in the RFI

48 The IFRS 9 approach to classifying and measuring financial assets was developed in response to long-standing and widespread stakeholder views that the approach in IAS 39 was too rule-based and complex. IAS 39 had many classification categories for financial assets, each category with its own rules for determining which financial assets were required or permitted to belong to that category, and for identifying and measuring impairment. IFRS 9 provides a principle-based approach that applies to all financial assets. That approach aligns measurement with the contractual cash flow characteristics of the assets and the way the entity manages them. Measurement aligned to both these factors provides users of financial statements with useful information about the amount, timing and uncertainty of the entity's future cash flows.

49 The IASB retained the IAS 39 classification and measurement requirements for financial liabilities substantially unchanged in IFRS 9 because feedback suggested the requirements for financial liabilities in IAS 39 worked well. However, IFRS 9 addressed the one issue consistently raised by constituents regarding financial liabilities—the so called 'own credit issue' relating to gains and losses arising from changes in the credit risk of financial liabilities an entity elected to be measured at fair value through profit or loss.

EFRAG's tentative position

EFRAG is of the view that the classification and measurement requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how an entity expects to manage them.

Nevertheless, there are areas of attention, such as the use of administrative rates, financial instruments with ESG features, etc, which are described in detail in our response to Question 3.

Summary of constituents' comments

50 EFRAG received nine responses to Question 1.

Question (a)

51 Seven out of nine constituents (user organisation, four national standard setters and two preparer organisations from insurance industry) agreed with the EFRAG draft response that the classification and measurement requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how an entity expects to manage them.

52 One constituent national standard setter precises that classification and measurement principles in IFRS 9 resulted in a reasonable classification of financial instruments in its jurisdiction and highlighted the significant burden to prove that banking book passed the SPPI test in the stressed market situations.

53 Another constituent national standard setter considered that the classification and measurement requirements in IFRS 9 only partially enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them. This constituent noted that there are several aspects of the classification and measurement requirements including unexpected effects arising from the application of the rules that, in this constituent's view, call for further discussions. These aspects are described further in the letter.

54 Five constituents, representing insurance industry, and two national standard setters considered that the current IFRS 9 measurement rules for equity and equity-type financial instruments do not always adequately reflect the holders' applicable business model under which an investment in an equity instrument is held (long-term holding versus trading purpose) and use FVTPL as an anchor point. It was noted that this issue was particularly relevant for insurance entities.

55 These constituents highlighted as particularly problematic the inability to account for equity instruments and investments in private equity at FVOCI with recycling when they do not pass the SPPI test, although they meet the business model condition (i.e., they are not held for trading purpose). Please refer to Question 4 for more details.

56 Two constituents from insurance industry noted that the application of the SPPI cash flow criterion to new types of investments may be challenging, specifically in case of financial instruments whose contractual cash flows are linked to ESG target achievements. They considered that given the expected growth on green bonds investments, a solution should be found to avoid volatility in profit or loss caused by the SPPI requirements not being met by these types of bonds. Please refer to Question 3 for more details.

Question (b)

57 Six constituents (user organisation, preparer organisation from the insurance industry and four national standard setters) agreed that on overall classification and measurement requirements of IFRS 9 based on the business model provide information that is useful for users to assess the amounts and timing of future cash flows.

58 Two constituents, user organisation and a national standard setter, indicated their preference for amortised cost accounting when assessing a financial institution's banking book. Using fair value measurement ('the valuation overlay') limits the predictive value of the net interest margin. In their view, amortised cost accounting provides useful information for financial assets that have limited variability in their contractual cash flows.

59 One constituent national standard setter mentioned that in certain areas, such as reclassification, the IFRS 9 requirements do not always result in useful information for the users of financial statements. These areas are described in further questions.

60 Another constituent national standard setter shared practical concerns of applying IFRS 9 recognition and measurement requirements highlighted by stakeholders in its jurisdiction:

(a) assessing whether an asset has cash flows that are SPPI is subject to the utmost attention and requires 'bespoke' and thorough analysis. By removing the option to bifurcate embedded derivatives in financial assets, the existence of variability in contractual cash flows can thwart the eligibility to amortised cost accounting, thus leading the SPPI to play a pivotal role in determining an asset's measurement basis. The SPPI test has even led some entities:

  (i) to limit or waive the origination of some instruments (loans with participation rights for example); or

  (ii) to modify the contractual features of the instruments they originate to pass the SPPI test, or to avoid the 'benchmark test' in paragraphs B4.1.9B-B4.1.9. D of IFRS 9.

(b) assessing the business model within which a financial asset is held can be complex and requires the use of judgement (see the answer to Question 2).

Question 2 – Business model for managing financial assets

(a) **Is the business model assessment working as the Board intended? Why or why not?**

Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

(a) **Can the business model assessment be applied consistently? Why or why not?**

Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient.

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(b) **Are there any unexpected effects arising from the business model assessment? How significant are those effects?**

Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

Proposals in the RFI

61 In the context of IFRS 9, a 'business model' refers to how an entity manages its financial assets to generate cash flows - by collecting contractual cash flows, selling financial assets or both. Consequently, classification and measurement based on the business model provides information that is useful in assessing the amounts, timing and uncertainty of an entity's future cash flows.

62 An entity determines the business model at a level of aggregation that reflects how it manages groups of financial assets to achieve a business objective. An entity's business model is typically observable through the entity's activities to achieve its business objective. An entity considers all available relevant evidence to determine the business model.

63 *Changes in the classification and measurement of financial assets subsequent to initial recognition can make financial statements more difficult to understand, particularly when comparing information from period to period. Therefore, the IASB established conditions for reclassification that it intended would be met only on occurrence of a significant event. IFRS 9 requires financial assets to be reclassified between measurement categories when-and only when-the entity's business model for managing them changes. In accordance with IFRS 9, a change in business model is a significant event and is expected to be rare.*

EFRAG's tentative position

EFRAG considers that the combination of cash flow characteristics of the assets together with the assessment of the entity's business model generally provides an appropriate basis to align the measurement of financial instruments with how they are managed by the entity.

EFRAG has been informed that in some circumstances the business model could not be applied consistently, however EFRAG does not consider that further standard-setting activity is needed as the existing IFRS 9 requirements result in appropriate outcomes.

Summary of constituents' comments

Question (a)

64 Six constituents, one user organisation, one national standard setters, one preparer-insurer and three preparer organisations from the insurance and banking industry agreed with EFRAG's view that no further standard settings should be contemplated mainly because IFRS 9 provided sufficient guidance to conduct a consistent and sustainable business model assessment.

65 One preparer organisation from the insurance industry welcomed the inclusion of the business model "Hold to Collect and Sell" which will be very relevant for insurers and is expected to be widely used within the insurance industry.

66 However, another constituent preparer organisation from the banking industry noted that several discussions arose on the issue on how to apply the business model requirements under the COVID, on how to understand the requirements for permitted sales under the 'held to collect' business model. He would welcome more guidance in this area, but this should not be high priority topic for the IASB.

67 One constituent national standard setter considered that the business model assessment only partially works as the IASB intended as at later point in time did not always provide users of financial statements with useful information at initial classification according to IFRS 9.4.1.

68 Additionally, one constituent national standard setter noted that the application of the standard did not always result in useful information for users of financial statements. He mentioned that the requirements for reclassification of particular financial assets should be reassessed by the IASB to determine if there was a need for adjustment of the existing accounting requirements according to IFRS 9. Therefore, he recommended the IASB to provide more examples and guidance regarding the assessment of demonstrability of a change in the objective of the entity's business model to external parties and significance for the entity's operations.

69 One constituent, national standard setter noted the IASB should undertake standard setting to consider permitting reclassifications in circumstances other than those specified in paragraph B4.4.1 of IFRS 9.

70 He noted that reclassifications of financial assets were highly restrictive and may ultimately result in circumstances in which the business model in IFRS 9 no longer reflected the manner an entity manages the assets. Even when:

(a) there was a change, but it was not demonstrable to external parties, which could often be the case for changes relating to banks' treasury or liquidity portfolios that were not 'customer facing', or because the change was not significant to the entity; and

(b) there was a syndication process[1].

71 Finally, this constituent – national standard setter noted that some entities were rebalancing their portfolios which were linked to 'ESG investment strategies'. Such sales arose, or were expected to arise, because the regulatory framework compels financial institutions to:

(a) invest in assets fostering the transition to a green economy; and

(b) disinvest assets that are not part of that transition (for example, reducing the funding to carbon intensive industries).

72 For current originations of financial assets' portfolios, there were questions about whether the expectation of such sales to arise might preclude from assessing that those assets are being held within a HTC business model[2].

Question (b)

73 One preparer organisation from the insurance industry highlighted that they were not aware of any diversity in practice in this regard. In addition, as response to what it was mentioned in paragraph 64, one user organisation noted they would like a more concrete explanation from EFRAG on which circumstances the business model cannot be consistently applied.

74 Two constituents-national standard setters added that while management's intention of managing financial instruments may change over time, reclassification is only possible under restrictive circumstances such as when an entity either begins or ceases to perform an activity that is significant to its operations. In their view, the need for reclassification arises more frequently than the IASB expected. This causes inconsistency because the business model assessment for initial classification is undertaken on portfolio or sub portfolio level.

75 Additionally, one constituent national standard setter mentioned that the business model assessment according to IFRS 9 triggered a change in real business models increasing diversity in practice. Banks had to assess and manage their financial position in a very dynamic environment which was increasingly influenced by regulatory requirements. Although the business model may be applied consistently with management's initial intention at inception and over lifetime, changes in

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[1] An entity exactly knows the part of the loan it will retain at the end of the process (it will be eligible to a business model whose objective is to hold financial assets in order to collect contractual cash flows (HTC)) and the part it will sell to other parties part through the syndication process (it will be neither eligible to a HTC business model nor to a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (HTCS))

The syndication process (which usually lasts several weeks) may result in the entity retaining a proportion that is different from the one it estimated at inception. In those circumstances, the entity may ultimately hold a proportion of the loan in excess of the proportion it estimated at the outset of the process. The business model for this 'in excess proportion' (or unsold part) cannot be changed to HTC at the end of the syndication process.

[2] On originations that will occur in the mid or long terms, no such matter will arise as the newly originated assets are expected to comply with the ESG strategy of financial institutions.

regulatory requirements may force management to adopt new regulations and hence changed the business model accordingly. This constituent observed that this resulted in either an inconsistent presentation in the financial statements or a change in how banks manage their portfolio.

76 One constituent preparer organisation from the insurance industry specifically supported that the business model assessment did not depend on management's intentions for an individual financial instrument. It was indeed important for him that the business model assessment continues to be determined at a level of aggregation that reflects how the reporting entity manages portfolios of financial assets to achieve a business objective.

77 Furthermore, this constituent preparer organisation from the insurance industry was fully supportive of the existing conditions established for reclassification of financial assets after initial recognition and agreed with the IASB expectation that they would be met only on a rather rare occurrence of a significant event leading to a change in the business model for managing them.

Question (c)

78 One constituent preparer organisation from the insurance industry mentioned that they did not experience unexpected effects from the business model assessment so far. In this regard the standard was cost-effective from the perspective of reporting entities and provided useful information to investors and other users of financial statements.

79 Another constituent national standard setter noted the business model assessment was an area of stakeholders' scrutiny. Further application guidance in this respect could help reducing the costs entailed by this assessment.

Question 3 – Contractual cash flow characteristics

(a) Is the cash flow characteristic assessment working as the Board intended? Why or why not?

Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows.

If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

(i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

(ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk). (See Section 7 for more questions about applying the effective interest method.)

(b) Can the cash flow characteristics assessment be applied consistently? Why or why not?

Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features).

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

Proposals in the RFI

80 *Amortised cost is a simple measurement technique that allocates interest payments using the effective interest method over the life of a financial instrument. In the IASB's view, amortised cost can provide useful information only if the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. Therefore, one condition for determining how to classify and measure a financial asset is whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI). Only financial assets with SPPI cash flows are eligible for measurement using amortised cost or fair value through OCI, subject to the business model in which the asset is held.*

81 *The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest are always closely related to the amount advanced to the debtor. The effective interest method, combined with the expected credit loss impairment model, provides relevant information for financial assets with SPPI cash flows. When the Board developed IFRS 9, it noted that the effective interest method is inappropriate for allocating cash flows that are not SPPI.*

82 *Unlike IAS 39, IFRS 9 does not require or permit embedded derivatives to be separated from financial asset. Accordingly, an entity assesses the contractual cash flow characteristics of a financial asset in its entirety.*

EFRAG's tentative position

EFRAG considers that the principle underlying the SPPI requirement generally leads to useful information. However, the SPPI test guidance requires a re-evaluation in the light of specific financial instruments such as financial instruments with ESG features or contractually linked financial instruments. EFRAG proposes that the issue of financial instruments with ESG features is removed from the IFRS 9 PIR process and treated separately as an urgent issue resulting in potential targeted improvements to IFRS 9.

Summary of constituents' comments

83 Five constituents (two preparer organisations from the insurance and banking industry, one preparer-insurer, two national standard setters) agreed that the cash flow characteristics assessment is working as the IASB intended. Four constituents (one user organisation, one preparer organisation-insurer, two national standard setters) added that it (generally) leads to useful information.

84 One constituent national standard setter was of the view that the cash flow characteristics assessment does not entirely work as intended because of how financial instruments with ESG features are assessed.

85 Thirteen constituents (user organisation, four national standard setters, six preparer organisations from the insurance and banking industry, two preparers – insurer-bank noted that issues arise for financial instruments with ESG features. These constituents noted the following comments and arguments:

(a) Measuring financial instruments with ESG features at amortised cost leads to useful information for users.

(b) These features were not common when IFRS 9 was issued.

(c) ESG instruments are part of a new market segment where compliance with certain ESG clauses reduces credit risk. While this holds for long term financing, ESG compliance might arguably not affect the credit risk of short-term financing to the same extent.

(d) While it is quite intuitive that in the future ESG compliance by counterparties in the long run will mean a lower credit risk, the financial and the non-financial data currently available, both actual and historical, either has not been compiled or it is not available to empirically evidence that in the long run, ESG compliance by counterparties will mean a lower credit risk. The concrete and operational implementation of the various regulations within the next years is expected to provide further evidence to corroborate this conclusion.

(e) Paragraph BC4.182(b) of IFRS 9 does not require an exact calculation of what the credit risk component or its changes would be. As a result, it may be sufficient if entities could prove positive correlation between the target fulfilment and the credit risk improvement and that the positive margin adjustment does not clearly overstate this improvement (i.e absence of leverage).

(f) Establishing a link between ESG risks and the credit risk of the borrower is not, in itself, sufficient—IFRS 9 requires that the credit risk of a financial asset is for the credit risk associated with the principal amount of that particular financial asset. This means an entity has to demonstrate that the sustainability performance target specified in a sustainable linked loan affect the probability of defaulting on that particular loan—this demonstration is complex to make in practice.

(g) International supervisors and regulators, as well as supervisors and regulators in certain jurisdictions like Europe, share a consensus to consider, from a prudential point of view, that ESG risks are indeed a component of credit risk (but also of other elements of basic lending risks within the meaning of IFRS 9) likely to affect the interest rate.

(h) It can be argued that lower interest rates due to ESG compliance are SPPI compliant as banks reduce their profit margin. The reduction of the profit margin may make sense economically as banks can improve their green asset ratio and reputation. Furthermore, green loans may not only improve a bank's reputation, but might also serve as the basis for the issuance of green notes (liabilities) and thus more attractive and cheaper funding. This makes liquidity/funding cost another argument, why (certain) ESG clauses should be seen to be compliant with the definition of basic loan features.

(i) The application of the cash flow characteristics assessment is not consistent throughout IFRS 9 requirements. When comparing fixed rate loans, variable rate loans, last-reset rates due to IBOR reform (all SPPI-compliant) there is an inconsistency with the treatment of smoothed variable interest rates (less volatile than outright variable rates).

(j) The IASB should consider this issue as an urgent issue (separately from PIR IFRS 9).

(k) While defining a separate basic lending treatment for financial instruments with ESG features, qualitative boundaries could be set.

(l) If the default subsequent measurement attribute is FVTPL, this measurement might not be reflective of the amount, timing and uncertainty of the cash flows from such instruments. A fair value measurement would lead to unsubstantiated profit or loss volatility resulting from:

(i) changes in benchmark interest yield curves; and

(ii) market-based measurement of credit and other spreads.

86 In contrast, investment products where the terms and conditions depend on KPIs related to ESG indices or other indicators *that are not specific to either party of the contrac*t such products should be treated differently from financial instruments with ESG features that depend on the behaviour or one of the parties of the contract.

87 One constituent – user organisation noted that financial instruments with ESG features should continue to be measured at amortised cost. No change in the measurement basis should be applied if the estimated cash flows remain largely unchanged based on the contractual agreement: if the ESG feature implies an adjustment in the interest rate, the estimated cash flows remain largely unchanged because and the asset should be measured at amortised cost. However, if a different type of adjustment becomes applicable, the loan should be adjusted to fair value. In addition, changes to comply with sustainability criteria or KPI's should be disclosed.

88 One constituent – national standard setter noted that measuring financial instruments with ESG features at fair value would not result in useful information for the following reasons:

(a) Amortised cost has more predictive value for those instruments than fair value measurement-the users they consulted confirmed this view.

(b) It would be questionable to 'fair value' all risks embedded in the instrument just because of the ESG risk-this is one risk among other risks inherent to a basic loan arrangement and this risk is not expected to outsize other risks. This is because, most of such risks (benchmark interest rate risk, credit risk not related to ESG-risk, liquidity, capital, etc.) are priced with a fixed component whereas the ESG component may be repriced at market. Therefore, measuring such loans at their fair value in their entirety would mostly consist in measuring the fixed components of such loans whereas amortised cost is deemed to be the measurement basis that better reflects the estimation of future cash flows when such assets are held into a HTC or HTCS than fair value.

(c) Those instruments are, in principle, funded and are not structured to introduce 'leverage'.

(d) Measuring at fair value those instruments would be complex to operationalise.

89 One constituent – national standard setter noted that sales of financial assets arising in the context of a transition towards a green economy may affect the business model (for more detail please refer to paragraph 71 above).

90 Other financial instruments where the cash flow characteristics assessment does not lead to useful information – or require further standard setting activities - according to constituents were:

(a) Fund structures/puttable instruments as the fund investment is only indirect and not always sufficient information are provided to fulfil the SPPI test. When a substantial part of the underlying debt instruments held by a fund pass the SPPI test, the investment should be eligible to the FVOCI option under IFRS 9.

(b) Sukuk investments (i.e., investments in Islamic bonds) as they do not lead to interest payments in legal perspective. But they often have the intention to provide similar cash flows to investors as simple debt instruments do.

(c) Hungarian baby boom loans (for more detail refer to paragraph 98 below).

(d) Notes/bonds issued through an SPV (Special Purpose Vehicle) within the framework of a supply-chain financing program of a corporate which are backed by the suppliers' collection rights against the debtors (for more detail refer to paragraphs 101 to 103 below).

(e) Non-recourse assets (for more detail refer to paragraphs 104 to 105 below).

(f) Contractually linked instruments (for more detail refer to paragraph 108 below).

Question 3 – Questions to constituents

Question to constituents - Question 3 (a)

91 In addition to the issue of the application of the SPPI test to financial instruments with ESG features and to the requirement to classify at FVTPL mutual funds and other puttable instruments (see our answer to Question 4 below) that have been identified in this DCL, are there other fact patterns for which you think the cash flow characteristics assessment is not leading to an appropriate measurement outcome? Please consider, in particular, financial assets that are required to be measured at FVTPL, for which a different measurement approach (amortised cost or FVOCI) would be in your view more appropriate. Please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk).

Questions to constituents – Financial instruments with ESG features

92 When applying the SPPI test to financial instruments held to collect that have contractual cash flow variability linked to ESG targets specific to the borrower, what additional approach could be considered in order to avoid failures of the SPPI test? Approaches used currently include considering the 'de minimis' and the possible link to the credit spread.

93 Do you think that failing the SPPI test (and a resulting measurement at fair value through profit or loss) is an appropriate outcome for these financial instruments? Please specify.

94 What do you consider the economic nature of the ESG-linked variability to be?

Question to constituents – Question 3 (b)

95 In addition to financial assets which are in the scope of the contractually linked or non-recourse guidance identified in this DCL, are there other fact patterns to which you think the cash flow characteristics assessment cannot be applied consistently?

Question to constituents – Question 3 (c)

96 In addition to the unexpected costs of applying the SPPI test to instruments with administrative rates identified in this DCL, are there other fact patterns that show unexpected effects arising from the cash flow characteristics assessment?

Summary of constituents' comments

97 The following paragraphs only reflect detailed messages that are not included in the summary for Question 3 Contractual cash flow characteristics (paragraphs 83 to 89).

Question 3a

98 One constituent – preparer organisation - banking industry referred to Hungarian loans within a government program to help with the growth of the population ("baby boom loans"). The product includes a leverage factor that fails SPPI (i.e. interest formula is as follows: Interest = 1.3 x (5Y government bond yield at disbursement) + 200 bps). Amortised cost classification would be a more appropriate classification since the leverage is imposed by the government. In this respect they would propose to delete the last half sentence of IFRS 9. B4.1.9E. "*However, despite paragraphs B4.1.9A–B4.1.9D, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) 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."~~*

99 One constituent - preparer organisation - banking industry noted that issues arise for certain equity instruments which are not traded. For example, companies whose value of shareholder's equity is not equivalent to its liquidation value because of contractual agreements with shareholders or due to state regulations, such as in Mutual Guarantee Companies. In this case, a measurement model based on acquisition cost plus an impairment test if there is evidence of an incurred or expected loss would work much better.

Question 3a - Financial instruments with ESG features

100 One constituent – preparer organisation – banking industry noted comments in relation to financial instruments with ESG features often focus on the 'E' aspect, but one should certainly not forget the 'S' and 'G' as the evolution is towards a sustainable and inclusive society. In addition, there is a need for a certain ring fencing to allow, for example, leverage elements to fail SPPI.

Question 3b

101 One constituent – preparer organisation - banking industry noted that IFRS do not include guidelines defining when a financial asset should be classified as a loan or as a debt instrument. From the purchaser's perspective, there is uncertainty on how to classify the notes when banks buy notes/bonds issued through an SPV (Special Purpose Vehicle) within the framework of a supply-chain financing program of a corporate which are backed by the suppliers' collection rights against the debtors.

102 The operation would be as follows: The SPV acquires from the suppliers the collection rights against the debtors and, subsequently, issues debt to finance those collection rights. The debtors pay the SPV the amount owed to their suppliers and the SPV settles the debt issued as a bond. Therefore, the only difference with respect to traditional reverse factoring, which is recognised currently under IFRS 9 as a loan, is that banks do not directly acquire the suppliers' collection rights, but acquire the notes issued by an SPV, the underlying of which are the suppliers' collection rights. The following are characteristics of these notes:

(a) the bonds' credit risk encompasses the credit risk of the debtor of the invoice (this does not change due to the fact of adding an SPV to the operation);

(b) from a legal perspective, these bonds are considered as a debt instrument and, thus, are identified by an ISIN code; and

(c) these bonds are not listed on any regulated market and are traded in a flat secondary market They are financial assets that, due to their characteristics, would pass the SPPI test; therefore, they could classify them at amortised cost or at FV-OCI (according to the business model).

103 Clarification would be useful whether in such cases the decision on their recognition should be made considering the legal form of the financial asset being acquired or the characteristics thereof, regardless of its legal form.

104 One constituent – preparer-bank noted that the guidance for non-recourse assets should be improved. Paragraph B4.1.16 of IFRS 9 mentioning the non-recourse asset starts with an example of a financial asset where the cash flows increase as more automobiles use a particular toll road. They note that such a feature would be non-SPPI in general and does not have to be mentioned in connection with discussing non-recourse assets.

105 Despite the fact that accounting practice has evolved in assessing the non-recourse features and they are not aware of inconsistent application it would be helpful to improve the guidance. IFRS requirements should also address “in substance” non-recourse financial assets which do not relate to explicit contractual terms but result e.g., from funding provided to special purpose entities, investments in funds or project financing loans.

106 Regarding the scope of the contractually linked and non-recourse guidance they agree with the EFRAG analysis and the need for additional guidance.

Question 3c

107 One constituent – preparer organisation-banking industry noted that the issue of administrative rates should be addressed, while another one – preparer noted that this was an irrelevant issue for the PIR.

108 One constituent – preparer organisation-banking industry noted that the application of the contractually linked instruments’ guidance to confirm that the underlying pool of assets meets the SPPI requirement creates particular challenges. In most cases it is impracticable or not possible at all to confirm that every asset in the pool is SPPI. A relaxation or amendment of this element of the CLI guidance may remediate the issue. They would be in favour of a simpler test especially for the senior tranches. This is also referred to in paragraph 45(a) in EFRAG’s DCL.

Question 4 – Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in other comprehensive income working as the Board intended? Why or why not?

Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied).

For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

(b) For what equity instruments do entities elect to present fair value changes in other comprehensive income?

Please explain the characteristics of these equity instruments, an entity’s reason for choosing to use the option for those instruments, and what proportion of the entity’s equity investment portfolio comprises those instruments.

(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in other comprehensive income? How significant are these effects?

> Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.
>
> In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

Proposals in the RFI

109 Equity instruments do not have SPPI cash flows and therefore are measured at fair value through profit or loss. As explained in paragraph BC5.22 of the Basis for Conclusions on IFRS 9, in the IASB's view, fair value provides the most useful information about the amount, timing and uncertainty of the cash flows arising from investments in equity instruments.

110 The IASB acknowledged when it developed IFRS 9 that, in a narrow set of circumstances, presenting fair value gains and losses from equity investments in profit or loss may not be indicative of the entity's performance. Therefore, IFRS 9 permits an entity to make an irrevocable election at initial recognition to present in OCI changes in the value of an investment in an equity instrument not held for trading. Those gains and losses are not 'recycled' to profit or loss on disposal of the investment, and the investment is not subject to impairment requirements.

111 *Some constituents questioned whether non-recycling for investments in equity instruments in IFRS 9 is consistent with the Conceptual Framework for Financial Reporting. The Conceptual Framework explains that, in principle, income and expenses included in OCI in one period are reclassified into profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the IASB may, in developing Standards, decide that income and expenses included in OCI are not to be subsequently reclassified.*

EFRAG's tentative position

The absence of recycling has created significant constituents' concerns. EFRAG considers the IASB should expeditiously review the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

EFRAG supports that similar fact patterns should be treated similarly, and notes that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32 *Financial Instruments – Presentation.* Any changes to the accounting for these instruments, aimed at allowing for equity and equity-type instruments to be treated similarly for accounting purposes, would require careful consideration. It would be necessary to evaluate the challenges of developing an appropriate standard-setting solution and considering knock-on effects on the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and the ability to assess the nature of the underlying assets and business model at the level of the fund itself. As a working assumption, EFRAG considers that the definition of equity-type instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives, and necessary cash holdings.

Summary of constituents' comments

Question (a)

112 Eleven constituents, six national standard setters, one preparer-insurer and four preparer organisations from the insurance and banking industry agreed with EFRAG that absence of recycling has created significant constituents' concerns.

113 Three constituents two national standard setters and one preparer organisation from the banking industry emphasized that the need for recycling of equity instrument will increase when IFRS 17 is implemented. The IASB should ensure that:

(a) profit and loss portrayed faithfully the financial performance for all long-term investors; and

(b) the current classification and measurement requirements in IFRS 9 did not give rise to accounting mismatches in the financial statements.

114 Two constituents national standard setters noted since shadow accounting[3] is no longer permitted in IFRS 17, the lack of recycling will increase accounting mismatches for those insurance companies that have profit sharing features in their insurance liabilities.

115 One constituent national standard setter noted its local GAAP was partially amended to be aligned with IFRS 9 for the annual financial statements of all non-financial entities and for the consolidated financial statements of entities not required to apply IFRS and that voluntarily follow the local standard.

[3] Paragraph 30 of IFRS 4 stablishes that "*An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income.*"

116 According to that, for those equity instruments measured at FVOCI at initial recognition irrevocably designated, in case of impairment or derecognition the accumulated income or losses should be reclassified to the profit and loss account to preserve the general principle that the company's profit or loss was reflected in the profit and loss account at a given point in time.

117 One constituent preparer organisation from the banking industry expressed mixed views from its own constituents. Some believed that FVOCI accounting treatment for equity instruments designated under this option should be reviewed and allow recycling through the profit and loss account. This would also mean reintroducing impairment on these instruments. Others believed that the current accounting treatment is appropriate, and they were able to properly manage their equity portfolio under the current standard. In particular, these constituents believed that the previous impairment test for equities under IAS 39 was too ambiguous and difficult to implement.

118 One preparer organisation from the insurance industry assessed that the time of disposal was a valid basis for identifying the period in which reclassification would have to occur. And the amount to be reclassified could be easily and properly determined with reference to the underlying investment being disposed. In addition, IFRS 7 already requires disclosures about the investments for which the FVOCI option was exercised and about the reasons for disposing of the investments if any, including the related cumulative gain or loss in such a case.

119 One constituent – preparer-bank-insurer provided quantitative inputs about the impact of applying IFRS 9 and IFRS 17 together. The change from IAS 39 to IFRS 9 would lead to an increase in profit and loss volatility and as a result they would have to sell off large volumes of the listed equity instruments they are holding. As an illustration, at the start of the Covid 19 pandemic (Q1 2020), the market volatility would have reduced their net results by 86% (if not corrected by the overlay approach).

Question (b)

120 Eight constituents (four national standard setters, one preparer-bank and three preparer organisations from the insurance and banking industry) agreed with EFRAG that similar fact patterns should be treated similarly.

121 One constituent national standard setter mentioned that the definition of equity-type instrument on its local GAAP was *"acquired equity instruments of other companies, e.g., shares, mutual fund units and other equity instruments".*

Question (c)

122 One constituent national standard setter mentioned that the option to present changes in the fair value of investments in equity instruments in OCI resulted in an increased amount of Level 3 disclosures where under IAS 39 the paragraphs AG80 and AG81 would have been applied.

123 One constituent user organisation considered that preparers should be the ones to address this issue.

Questions to constituents – Questions 4 (a) and (b)

FVOCI option for equity instruments

124 For which equity instruments has the option to present fair value changes in the OCI been applied? What are the reasons for choosing to use the option for those instruments? What is their proportion of the overall investment portfolio?

125 From a user perspective, do you think the absence of recycling of gains or losses of equity instruments designated at FVOCI provides useful information? Please explain.

Treatment of equity-type financial instruments

126 If you consider that equity-type financial instruments should be accounted for similarly to equity instruments, how would you define 'equity-type'? What type of underlying investments should be considered? How a classification test could be structured, taking into consideration among other things the need to assess the characteristics of the underlying assets?

127 From a user perspective, do you think that expanding the possibility to use FVOCI for equity-type financial assets provides more useful information? Please explain.

Summary of constituents' comments

FVOCI option for equity instruments

128 Nine constituents (three national standard setters, one preparer-insurer and five preparer organisations from the insurance and banking industry) noted that realised gains and losses on instruments measured at FVOCI should be recycled over profit and loss to contribute to total profit and strengthen the position of accrual accounting and profit and loss as measurement of performance.

129 One constituent, national standard setter, noted the need of transparency around the 'recycling' in profit or loss could be considered in the context of the *Primary Financial Statements* standard-setting project.

130 Six constituents' (four preparer organisations from the insurance and banking industry, one national standard setter and one preparer-insurer) mentioned that the reintroduction of recycling was necessary for equities measured at FVOCI since it would significantly improve the faithful representation of the financial performance of companies. Just as dividends, gains and losses realised on disposal of equity instruments measured at FVOCI were an integral part of a company's performance and should be shown in the results. As such, there was no conceptual reason to make a distinction between these different sources of profits and loss.

131 One constituent user organisation considered the non-recycling made difficult to understand how equity evolves over periods despite the statement of changes in equity and it would not contribute to the principle of good financial reporting.

132 In addition, three preparer organisations from the insurer and banking industry noted that the current requirements entail the risk that equity markets may include the dividend policy in their pricing models and in this way put additional pressure on companies to maximise dividend distribution. One of them (banking industry) mentioned that there might be an impact on the pricing of high dividend yield equities versus growth equities. Financing start-up and young companies could also suffer competitive disadvantage as typically they were unable to distribute dividends in the early years of their activities. Another one (insurance industry) added that on average since 1930, returns on capital have been more significant (5,5%) than from dividends (4.1%).

133 One preparer organisation from the banking industry highlighted that reporting consistently all the components of the performance of equity instruments in profit and loss would provide complete and appropriate information to users about the performance of the related investments. This would also ensure consistency with the accounting treatment of debt instruments accounted for at FVOCI.

134 One constituent, preparer organisation from the banking industry considered that from a user point, the absence of recycling of gains and losses of equity instruments designated at FVOCI did not provide useful information in certain cases and considered that recycling would be a better accounting treatment. Those cases were the ones mentioned in paragraph 113.

135 Two preparer organisations from the insurance industry acknowledged the Conceptual Framework states that amounts should be recognised in profit and loss when it resulted in more relevant information. Therefore, all gains and loses should be presented in profit and loss at some point in time.

136 One preparer organisation from the insurance industry noted that an additional reason why the reintroduction of recycling for FVOCI equities was important, mainly for the insurance sector was the matching with the insurance liabilities that they covered.

137 Five constituents (three preparers' organisation from the insurance industry, one national standard setter and one preparer-insurer) suggested developing further the requirements in IAS 39 for the impairment of investments or including rebuttable quantitative impairment triggers in an impairment model for FVOCI:

(a) the impairment would be assumed and recognised in profit or loss for an equity investment at the reporting date if either its current fair value is more than 20% below the acquisition cost or its current far value has remained below the acquisition cost for more than the last 9 consecutive months; or

(b) the impairment would be assumed and recognised in profit or loss for an equity investment at the reporting date if either its current fair value is more than 25% below the acquisition cost or its current far value has remained below the acquisition cost for more than the last 6 consecutive months.

138 One preparer-insurer mentioned the Standard may provide examples of thresholds that represent clear indicators for a significant or prolonged decline in fair value (e.g., more than 25%; more than 12 months) and those that do not (e.g., less than 15%; less than 6 months). These examples could help to define a bandwidth of applicable quantitative thresholds while narrowing down the room for judgment. In this context, the application examples in IFRS 10.B72, could serve as a good example case for such kind of guidance.

139 However, they all supported that this recommended rule-based impairment model for equities in IFRS 9 should be accompanied by reversals to be recognised in the profit and loss statement if the fair value recovers subsequently, generally to the extent the impairment loss was previously recognised in profit and loss.

Treatment of equity-type financial instruments

140 Seven constituents (four preparer organisations from the banking and insurance industry, one national standard setter and two preparers-bank-insurer) believed that classifying puttable instruments as debt from the perspective of the issuer also depicted a misleading view because the put option had no intrinsic value as the put option was merely there to provide liquidity to the investor[4]. If these instruments were classified as debt instruments purely because of the puttable feature, this would not represent the economic substance as the investor was fully exposed to equity risk at any time. It had no protection against a decrease in share price unlike a true put option. For those reasons, they proposed the following '*equity-type instruments could encompass any form of financial instrument that entitles the holder to a return based on the net assets of the fund*'.

141 One constituent preparer organisation from the banking industry mentioned that by simple application of IFRS 9, the debt would have to be measured at FVTPL (because of SPPI-failure) as most likely there would be equity risk inherent in the

[4] The put will be exercised at the pro rata amount of the (net asset value) NAV of the equity funds, which would generally be the same price as the market price for the pro rata amount of shares in the funds (which are mostly tradable on the market).

funds. FVOCI designation was not an option when the SPPI-test fails and since equity classification was not possible from the perspective of the investor[5].

142 One constituent preparer organisation from the insurance industry considered that it would be sufficient to explicitly clarify that those puttable instruments (as currently already defined in IAS 32 for the purpose of the presentation as equity in issuers' accounts) were in the scope of the FVOCI option for equites not held for trading in IFRS 9, through a narrow-scope amendment.

143 One constituent preparer organisation from the insurance industry proposed including funds in real estate or infrastructure. For that reason, equity-type instruments could encompass any form of financial instruments that entitles the holder to a return based on the net assets of the fund.

144 Two preparer organisations from the insurance and banking industry highlighted that insurers also invested in equities indirectly, for example through investment funds. Therefore, to provide relevant information for the performance of long-term investors, the accounting treatment of equity-type instruments such as UCITS[6] should also be eligible to the FVOCI category under IFRS 9.

145 Furthermore one preparer organisation from the insurance industry noted a lot of those UCITS appeared to have put options which were not genuine. Instruments such as ETFs may perhaps be puttable according to the prospectus, but they were never putted directly to the issuer. Accounting for those funds as debt instruments would also not properly depict the economic substance of those instruments.

146 Another preparer organisation from the insurance industry noted that non-consolidated investments in redeemable or puttable investment funds holding equity securities responded to movements in market variables in a similar way to equity instruments, for that reason they should also be eligible to FVOCI with recycling. The same rationale applies to accounting for private equity structures.

147 One preparer-insurer noted that they supported limiting this guidance to units of funds and puttable instruments that invested in equity instruments, associated derivatives and necessary cash holdings.

Question 5 – Financial liabilities and own credit

(a) **Are the requirements in IFRS 9 for presenting the effects of own credit in other comprehensive income working as the Board intended? Why or why not?**

Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

(b) **Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?**

[5] Instruments which contain a "put feature" give the right to the investor to sell back its share in an entity to the entity itself. Typically, these entities are known as open-ended funds (variable amount of capital). Since the investor has the right to redeem the share to the issuer of the share, the issuer has therefore an obligation to redeem which triggers a liability classification from the perspective of the issuer (unless conditions of IAS32§16A apply), and simultaneously it triggers a debt classification from the perspective of the investor.

[6] Including 'BEVEK' and 'SICAV'.

Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

Proposals in the RFI

148 *When developing IFRS 9, the IASB kept the classification and measurement requirements of financial liabilities in IAS 39 unchanged. The only issue that the IASB was told needed reconsideration was the profit or loss effects caused by changes in the fair value of a liability resulting from changes in the risk that the issuer will fail to meet its obligations for that liability.*

149 By retaining almost all of the requirements from IAS 39, the issue of credit risk was addressed for most liabilities because most liabilities continue to be subsequently measured at amortised cost or are separated into a host, which would be measured at amortised cost, and an embedded derivative that would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be measured subsequently at fair value through profit or loss.

150 The fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit). This means that when an entity's credit quality declines the value of its liabilities fall and, if those liabilities are measured at fair value, the entity recognises a gain (and if the entity's credit quality improves, the entity recognises a loss). Many users of financial statements and others found this result counterintuitive and confusing.

151 *To address concerns about counterintuitive and confusing results for those financial liabilities voluntarily designated at fair value through profit or loss, IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in OCI rather than in profit or loss (unless doing so would create or enlarge an accounting mismatch in profit or loss).*

EFRAG's tentative position

EFRAG is of the view that the requirements work as intended and has not received information that contradicts this view.

Summary of constituents' comments

152 EFRAG received eight responses to this question.

153 Six constituents (user organisation, two national standard setters, two preparer organisations from the insurance and banking industry and one preparer-insurer) out of eight agreed that the requirements for presenting the effects of own credit risk in OCI are working as intended. They capture the appropriate population of financial liabilities and result in useful information.

154 One constituent national standard setter highlighted the significant judgement involved in measuring own credit spread and auditing the calculations. This constituent noted that it might be difficult for users of financial statements to understand the rationale underlying the effects of own credit risk presented in OCI, because IFRS 7.10 does not require entities to disclose details about the calculation of own credit risk or the sensitivity of the amounts presented in OCI to that calculation.

155 One constituent, representing insurance industry, highlighted that for contracts with the fair value option, that contain one or more embedded derivatives to be separated that cannot be measured reliably, it might be difficult to present the effects of own credit risk in OCI, as the components of the instrument are closely linked and cannot be isolated easily. In this case, the whole instrument is designated at fair value through profit or loss to provide more useful and reliable information to investors and other users of financial statements.

156 This constituent noted that for such contracts, an isolated view on own credit risk without consideration of the interaction with the other components is difficult and may not result in the desired presentation. Moreover, as paragraph 2 of IFRS 13 defines the fair value as an exit price (including own credit risk), from the constituent's perspective, this constituent proposed that it would be more appropriate to recognise own credit risk in profit or loss as well. Consequently, the constituent suggested to consider allowing an option in this regard which would address such circumstances.

157 Another constituent from insurance industry noted that as the implementation of IFRS 9 and IFRS 17 is still ongoing for many insurers, if other issues arise in due course, they should be considered by the IASB as they arise.

Question 6 – Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?

Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities?

If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities' financial statements.

Proposals in the RFI

158 When contractual cash flows are renegotiated or otherwise modified, the modification could result in the entity derecognising or recalculating the carrying amount (gross carrying amount for financial assets) of the financial instrument.

159 IFRS 9 does not define 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 3.3.2 of IFRS 9 refers to the 'modification of the terms' of a financial liability.

160 When amending IFRS 9 to account for the effects of interest rate benchmark reform, the IASB acknowledged that the omission of a description of a 'modification' in IFRS 9. The IASB also admitted that the use of different wording to describe a modification of a financial asset and a financial liability, could lead to diversity in practice. The IASB suggested it might be helpful to clarify the requirements for modifications and to consider making a possible narrow-scope amendment to IFRS 9.

EFRAG's tentative position

EFRAG understands that the absence of a definition of "substantial modification" and of derecognition thresholds for financial assets in IFRS 9, has led to some diversity in practice of when a financial asset is derecognised or modified.

However, EFRAG also notes that practice has now been established and some do not consider that undertaking standard-setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

Summary of constituents' comments

Question (a)

161 Two constituents (one preparer organisation from the insurance industry and one preparer-insurer) mentioned that the requirements for modifications work as intended. Moreover, they supported a narrow scope amendment to introduce consistent wording for the description of a modification of a financial asset and a financial liability in order to clarify the requirements for modifications.

162 One constituent national standard setter mentioned that the requirements for modifications did not work as intended. The requirements for modifications for liabilities according to IFRS 9 3.3.1 to 3.3.4 did not change compared to IAS 39 and are sufficiently clear and did not create significant diversity in practice. However, the requirements of IFRS 9 5.4.2 for financial assets created diversity in practice regarding whether companies apply the requirements for a modification, a derecognition or a change in estimate to changes in the terms and conditions of a contract.

163 Another constituent preparer organisation from the banking industry added that the requirements for modifications to contractual cash flows were not working as intended when it concerned the restructuring of loans.

Question (b)

164 One constituent preparer organisation from the insurance industry mentioned that the requirements can be applied consistently to financial assets and financial liabilities.

165 Three constituents (two national standard setters and one preparer organisation from the banking industry) agreed with EFRAG that the absence of a definition of "substantial modification" and of derecognition thresholds for financial assets in IFRS 9, has led to some diversity in practice. However, two national standard setters and one preparer-bank agreed that practice has now been established by preparers.

166 One constituent, preparer-bank mentioned that some lack of guidance in IFRS 9 on when modifications of contractual cash flows of financial assets result in derecognition, but the issues have been addressed in the accounting practice. IFRS literature established by audit firms brought sufficient guidance in this respect and entities were able to develop their own policies. This preparer mentioned a lot of effort was dedicated for establishing clear criteria for determining what cash flow modification events lead to derecognition of financial assets. In addition, its discussion with its auditors inferred that the policies were applied in a consistent manner by entities and considered that no standard-setting activities were necessary.

167 One constituent national standard setter described some practical issues that ultimately lead to diversity in practice regarding the application of the modification requirements such as:

(a) Identifying whether an interest rate change is within the contractual terms or results in a modification (i.e., it could be argued that an implicit right to prepayment without a significant penalty implies an option to reduce the spread without modifying the original contract term).

(b) Requiring management judgement to differentiate between substantial modifications according to IFRS 9.B5.25 that leaded to the derecognition of a financial asset, modifications according to IFRS 9.B5.5.27 that did not lead to the derecognition of a financial asset and (partial) write-offs according to IFRS 9.5.4.4.

(c) Disclosure requirements relating to modifications were hard to understand and to provide.

(d) In the context of the COVID-19 pandemic there might be situations where, after modification of the contractual cash flows of a financial instrument, the resulting contractual cash flows may no longer be considered as SPPI. This raises the question how the features that were not SPPI-compliant after modification measures (e.g., government measures, like public debt moratoria, concessions granted by banks to their customers or a combination of both) should be treated.

168 According to paragraphs 5.4.3 or B5.5.25 of IFRS 9 the terms "modified" and "imperfect" were not defined. However, the underlying principle of IFRS 9 in paragraph B4.1.7A was that, if the financial instruments contained contractual terms that introduce exposure to risks or volatility in the contractual cash flows that was unrelated to a basic lending arrangement, the SPPI-criterion was considered as failed without performing a benchmark test. On those cases, amortised cost measurement of the restructured loans was not appropriate because this measurement method did not reflect the new risks introduced by the restructuring measures (paragraph BC4.23 of IFRS 9). For that reason, this constituent noted that IASB should provide further explanations when a modified financial asset shall be derecognised, including criteria for derecognition and practical examples illustrating the application of those criteria.

Question to constituents

169 Do you think that standard-setting activities from the IASB are required to deal with modifications of the cash flow characteristics? Please explain.

Summary of constituents' comments

170 One constituent national standard setter noted that the application of the modification rules required banks to develop and implement entirely new systems, which required substantial efforts and investments. Hence, an amendment or specification of the requirements might lead to further technical complexity and additional/higher costs for banks. Therefore, this constituent supported outreach activities in order to gain a better understanding on how preparers apply the modification requirements and how users understand the related disclosures.

171 Another constituent preparer organisation from the banking industry believed that standard-setting activities were required. He noted that it should be analysed whether the financial instrument should be derecognised or not when the modification of the contractual terms occurred. On the liability side the 10% test was clear but on the asset side this assessment was not so straightforward. In practice, it was very complex to implement and therefore very little used. There was also a wide diversity in practice. He noted that it would be easier and more consistent if the change in effective interest rate could be applied on a prospective basis.

Question 7 – Amortised cost and the effective interest method

> **(a) Is the effective interest method working as the Board intended? Why or why not?**
>
> Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.
>
> **(b) Can the effective interest method be applied consistently? Why or why not?**
>
> Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply.
>
> Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are.
>
> If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.
>
> In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

Proposals in the RFI

172 *The effective interest method is the method used to calculate the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.*

173 *The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity estimates the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but does not consider the expected credit losses (for financial assets). The calculation includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.*

174 *IFRS 9 provides requirements on using the effective interest method, including requirements to reflect changes in cash flows resulting from:*

(a) *modifications;*

(b) *movements in market rates of interest; and*

(c) *other changes in estimates (the so-called 'catch-up adjustment').*

EFRAG's tentative position

EFRAG considers that the effective interest rate method generally provides useful information and notes that IFRS 9 includes scope limitations or corrections to the method for particular financial instruments. EFRAG further notes that more and more financial instruments incorporate conditions such as TLTRO related loans and ratchet loans. The financial instruments including such conditions are pervasive in Europe. EFRAG notes that the application of the EIR poses practical challenges both for the initial and subsequent measurement.

EFRAG is collecting further information from constituents on fact patterns, prevalence and diversity in practice in accounting for such financial instruments.

Summary of constituents' comments

175 Two constituents – one user organisation, one national standard setter agreed that the effective interest rate method provides useful information for users. As more and more financial instruments incorporate conditions that might affect the future contractual interest cashflows entities should disclose the specific changes and adjust KPIs as needed.

176 One constituent national standard setter noted that the effective interest method cannot be entirely applied consistently. The guidance regarding certain issues is not clear, which causes diversity in practice. Some examples are:

(a) Where in the P&L should the NPV effect of a modification be shown and does the reporting depend on the underlying reason of the modification?

(b) What is the relationship between derecognition and modification result?

(c) How should margin grid loans be accounted for, IFRS 9.B5.4.5 or IFRS 9.B5.4.6?

177 Furthermore, it is not clear how certain fees paid or received should be included in the effective interest rate calculation and how the probability of cash flows should be factored into the estimation of future contractual cash flows. For example, it may be questionable whether the term "expected" refers to a minimum probability threshold that cash flows must have, so that they can be considered in estimating the effective interest rate or whether this threshold should be set to a "virtually certain" level. A recent example where this issue played a role is the TLTRO III programme.

178 One constituent – national standard setter noted implementation difficulties related to the requirements in paragraph B5.4.6. Applying this paragraph, an entity adjusts the gross carrying amount of a financial asset or amortised cost of a financial liability to reflect actual and revised estimated contractual cash flows. An entity presents the adjustment ('catch-up adjustment') in profit or loss as income or expense. They have been made aware that no IT system currently exists to automatically (i) determine the revised amount of the modified asset or liability and (ii) recognise the catch-up adjustment arising thereof. This is a manual process which, if applied to large population of contractual modifications, would be highly costly to implement. In their view, only significant information benefits would justify such implementation costs.

Question to constituents

48 How significant are these catch-up adjustments in accordance with paragraph B5.4.5 or B5.4.6 of IFRS 9 (please provide nominal amounts and expressed as a percentage compared to the interest revenue and expense calculated using the EIR – as disclosed per IFRS 7, 20(b))? Please provide information for the following reporting periods: 2018, 2019 and 2020.

Summary of constituents' comments

179 Four constituents – two preparer organisations from the insurance industry, one preparer-insurer, one national standard setter believed the effective interest method is working as the IASB intended (and can be applied consistently).

180 One constituent – preparer organisation from the banking industry noted the following situations where estimating the EIR is challenging:

(a) TLTRO operations;

(b) Loans or bonds with part of their remuneration being contingent interest (e.g., linked to inflation); and

(c) Circumstances in which the estimation of a joint EIR between two separate financial instruments leads to a different pattern or income recognition that provides more useful information compared to single EIR.

181 One constituent – preparer-bank provided quantitative information about the largest catch-up adjustment in their history. They consider that it would be helpful if the IASB provided some guidance for cases when it is not straightforward to decide whether changes in contractual interest rates are treated under paragraph B5.4.5 or B5.4.6 of IFRS 9. The noted that credit spread adjustments which are linked to changes of borrowers' financial ratios are treated under B5.4.5 by them, i.e. they result in the EIR recalculation. Moreover, they apply similar treatment for so called commercial renegotiations of interest rates. Any guidance by the IASB should confirm this established practice.

182 One constituent – national standard setter noted the following:

Determination of the effective interest rate at initial recognition

183 Referring to the tentative agenda decision of the Interpretations Committee of June 2021, with regard to Targeted Longer-Term Refinancing Operations, the constituent noted that only standard setting could achieve clarity in how to calculate the EIR for a TLTRO III tranche on initial recognition. They added to observe limited diversity in practice in their jurisdiction (where B5.4.5 is applied).

Accounting for subsequent changes in contractual cash flows

184 The constituent made the following recommendations in case the IASB Board were to undertake standard setting for modifications to contractual cash flows:

(a) Any clarifications to the requirements in IFRS 9 should make clear that the term 'market rate of interest' is linked to the concept of fair value in IFRS 13, and thus that any modification to a financial instrument resulting in repricing its interest rate to the market interest rate conditions does not result in any catch-up accounting. Users would be better served by a prospective adjustment to the EIR--the entity recognising interest revenue or expense at a rate portraying market conditions--than maintaining the original EIR.

(b) There could be questions about whether the accounting applied to changes to credit spreads of ratchet loans entirely aligns with the principle set out in paragraph a. above. The credit spread reset of such loans is indeed predetermined at the loans' inception- i.e. the credit spread reflects the market conditions at inception and thus, not necessarily those that will exist when the credit spread is increased (i.e. at the reset date) because future credit spreads are most often not observable at inception. Accordingly, they recommend the requirements in paragraphs B5.4.5 also apply when the predetermined rate changes are a reasonable approximation of the market rates of interest as observed at inception or (ii) if not observable at inception, the predetermined rate changes reflect the interest rate that would apply had the entity defaulted on the covenant.

(c) Applying the requirements in paragraph B5.4.6 of IFRS 9 to the circumstances in which the (i) instrument's maturity is extended and (ii) the revised interest rate is the weighted average of the initial interest rate and the market rate of interest at the renegotiation date results in information that is not useful. The entity would indeed (i) recognise a catch-up adjustment being the difference between the original interest rate and the market rate of interest over the revised remaining period and (ii) subsequently recognise interest revenue (or expense) applying the original EIR. In their view, this outcome is not economically meaningful. Accordingly, they think paragraph B5.4.5 should instead apply in those circumstances.

Presentation of catch-up adjustments

185 Entities usually present the catch-up adjustments to financial assets in the line item whose presentation is required by paragraph 82(a)(i) of IAS 1 Presentation of Financial Statements – i.e. the line item called 'interest revenue calculated using the EIR'. In addition, they have been made aware of entities presenting this item elsewhere in profit or loss--for example outside the net interest margin in a line item called 'cost of credit risk' when the catch-up relates to forbearance measures related to debt restructuring.

Question 8 – Transition

(a) Did the transition requirements work as the Board intended? Why or why not?

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

Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?

Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

Proposals in the RFI

186 Upon their transition to IFRS 9, entities were required to apply the Standard retrospectively, but with reliefs to address difficulties that might have arisen from retrospective application.

187 Applying some of those transition reliefs that relate to classification and measurement, entities:

(a) *assessed whether the objective of an entity's business model was to manage financial assets to collect contractual cash flows based on circumstances at* *the date of initial application of IFRS 9 rather than at the date the related financial instrument was initially recognised;*

(b) *assessed whether a financial asset or financial liability met the criterion for designation under the fair value option based on the circumstances at the date of initial application rather than at the date the related financial instrument was initially recognised;*

(c) *were permitted but not required to present restated comparative information on initial application of the Standard; and*

(d) *did not apply IFRS 9 to financial instruments derecognised before the date of initial application.*

188 As the IASB waived the requirement to present restated comparative information, it instead required entities to disclose the effect on classification of financial instruments of the transition to IFRS 9.

EFRAG's tentative position

EFRAG has no evidence that the transition requirements of IFRS 9 are not working as intended by the IASB.

Summary of constituents' comments

189 One constituent – national standard setter reports that the transition requirements worked well and that one unexpected issue they observed was that upon transition some banks reset the OCI movement of FVOCI portfolios to zero. Constituents from the insurance industry and one banking industry association expressed appreciation for the recent IASB Amendments on IFRS 17 and IFRS 9 Comparatives.

190 One constituent – preparer organisation from the banking industry questioned the usefulness of the continued transition disclosures, specifically referring to the need to disclose what the fair value of assets would have been which have been transferred to amortised cost and which were previously measured at fair value for that specific portfolio at the moment of transition.

Question 9 – Other matters

(a) Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?

Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

(b) Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?

Proposals in the RFI

191 The IASB is asking to share any information that would be helpful to them in assessing whether:

(a) *The objectives of the standard-setting project have been met;*

(b) *Information provided by the Standard is useful to users of financial statements;*

(c) *The costs are as expected for preparing, auditing, enforcing or using the information entities provide when applying the Standard; and*

(d) *The Standard can be applied consistently.*

EFRAG's tentative position

Based upon preparatory work for this consultation EFRAG notes a number of issues that arise when applying the Classification and Measurement requirements of IFRS 9 to some financial instruments that are prevalent in Europe.

Most of these topics have already been discussed in our answers to the above questions. Below are additionally discussed: factoring of trade receivables, and supply chain financing – reverse factoring (deserving standard-setting activities) and financial guarantees (EFRAG is seeking views on whether standard setting is necessary).

Summary of constituents' comments

192 One constituent – user organisation noted that the information provided by the reporting standards is very useful and believes that the benefit of their implementation outweighs the cost. At this point the completion of some of the ongoing projects should be a priority. They encourage EFRAG to continue reviewing and commenting on the Standards to improve their implementation albeit avoiding increasing their complexity.

193 Two constituents – one preparer-insurer, one preparer organisation from the insurance industry saw no further matters to be addressed.

194 One constituent – individual notes that the difference in accounting treatment of Virtual Power Purchase Agreement (VVPA) contracts under IFRS and US GAAP will, in most cases, result in more profit or loss volatility and in an increased administrative burden under IFRS. The reason for this is that under IFRS, these contracts are generally treated as derivatives, whilst under US GAAP they are treated as executory contracts due to being regarded as contracts without notional. He therefore suggests aligning the IFRS accounting treatment with US GAAP.

195 One constituent – national standard setter identified two areas for consideration by the IASB:

The interaction between IFRS 9 and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

196 They believe IAS 20, paragraph 9 suggests considering there are two units of accounts for TLTRO III loans could be more useful:

(a) The first unit of account would be a financial liability in the scope of IFRS 9 whose cash-flows correspond to main refinancing operations interest cash-flows + redemption amount and its initial fair value would be unaffected by the conditions attached to the TLTRO III programme. Accordingly, the fair value of that liability would generally equate the proceeds received and thus, no initial 'Day 1' difference would exist.

(b) The second unit of account would consist of the benefit the bank is getting when it fulfils the criteria to get the difference between main refinancing operations and Facility Deposit rate which is a grant in the scope of IAS 20 that would be recognised, initially measured and subsequently remeasured applying IAS 20.

197 They recommend the IASB undertake standard setting in this respect.

Contracts eligible to the 'own use exemption'

198 The assessment of whether a contract is scoped out of derivative accounting applying the own use exemption arises frequently for entities managing commodity contracts. There is a widespread perception among entities managing such contracts the existing application guidance could be substantially enhanced, in

particular in comparison to the application guidance existing in US GAAP. They encourage the IASB to consider whether the requirements in IFRS 9 could be further developed.

199 Additionally, the constituent has been made aware of an increasing number of transactions for which the existing requirements in IFRS 9 may be inadequate. Those refer to contracts for which the volumes of the underlying items (typically commodities) are higher than the entity's expected usage ('oversized contracts'). Applying the existing requirements in IFRS 9, such contracts are not eligible, in their entirety, to the 'own use exemption'. Such contracts become more frequent, in particular when the underlying item is a 'renewable energy'. This is because the supply of such energy type can be erratic (because the supply of energy depends on climate conditions for example). In those circumstances, entities will enter into contracts whose volumes are wittingly agreed to exceed the expected usage--this ultimately ensures that entities will be supplied with the volumes they need to carry out their normal operations.

200 Applying the existing requirements in IFRS 9, oversized contracts are considered as a unique unit of account. Such contracts are not eligible to the own use exemption and consequently, are accounted for as derivatives measured at fair value through profit or loss. In the view of this respondent, the IASB should consider treating those contracts as two units of accounts:

(a) the first unit of account would capture the volumes that are equivalent to the entity's expected usage--this unit of account would be eligible to the own use exemption i.e. the entity would not recognise any derivative.

(b) the second unit of account would capture the volumes that are in excess of the entity's expected usage--this unit of account would give rise to a derivative measured at FVTPL.

201 In the constituent’s view, distinguishing two units of account for those contracts would provide more useful information.

Questions to constituents

49 Would you have other fact patterns about factoring of trade receivables that in your view should be considered and/or have you experienced challenges in other aspects of both accounting and disclosing information on trade receivables factoring? Please explain.

50 Do you agree that additional illustrative examples specifically on trade receivables factoring would be helpful in ensuring consistent application of IFRS 9 derecognition principles?

Summary of constituents’ comments

202 One constituent – preparer organisation from the banking industry noted that the guidance under IFRS 9 regarding factoring is not new compared to IAS 39 and they believe that practice has been established, hence they feel it is not necessary to undertake standard-setting activities in this area.

203 One constituent – preparer-bank noted that additional guidance could be helpful as there may be inconsistencies in how the derecognition requirements apply.

Questions to constituents

51 How would additional guidance on (i) the principal agent area and (ii) derecognition benefit you in accounting for reverse factoring transactions? Please explain.

52 As users of financial statements, do you currently lack information on reverse factoring transactions? If yes, which information is missing? In your view does the bank act as an agent in these situations or as a debtor? Please explain.

Summary of constituents' comments

204 One constituent – preparer-bank noted that additional guidance could be helpful in communicating reverse factoring transactions with customers.

Question to constituents

53 Do you think that the IASB should provide educational guidance or make amendments to the standard-for financial guarantees? Why or why not?

Summary of constituents' comments

205 One constituent – preparer organisation from the insurance industry noted that in contrast to the issuer of financial guarantees, the holder of a financial guarantee is currently not allowed to account for financial guarantees received under IFRS 4/IFRS 17. Especially for insurance companies this different treatment of received and issued financial guarantees may result in an accounting mismatch, for example in the case of a reinsurance contract (e.g., retrocession, fronting or similar contracts).

(a) Therefore, they recommend that for companies accounting for financial guarantees issued under IFRS 4/IFRS 17 the alternative treatment under IFRS 4/IFRS 17 should also be allowed for financial guarantees received to prevent such an accounting mismatch.

(b) Their recommendation is that - similarly to the option already existent in IFRS 9 and IFRS 17 regarding the treatment of financial guarantees on issuers' side - a irrevocable choice should be established in an explicit way on the holders' side, irrespective whether the financial guarantee received constitutes a reinsurance contract or not. They acknowledge that a narrow-scope amendment solely to the scope of IFRS 9 and IFRS 17 might be necessary in this regard.

206 One constituent – preparer organisation-banking industry noted that IFRS 4 included an option that permitted an issuer of a financial guarantee contract to account for it as if it were an insurance contract, if the issuer had previously asserted that it regards the contract as an insurance contract. This option has remained under IFRS 17. In the constituent's view, this accounting choice should not be changed.

207 One constituent – preparer-bank noted that additional guidance could be helpful.

Appendix 2 – List of constituents

1 Comment letters received

Name of constituent	Country	Type/Category
EFFAS	Germany	User organisation
SFRB	Sweden	National Standard Setter
Draft 1	Austria	-----
EBF	Belgium	Preparer organisation
DASC	Denmark	National Standard Setter
Febelfin	Belgium	Preparer organisation
GDV	Germany	Preparer organisation
Assuralia	Belgium	Preparer organisation
ESBG	Belgium	Preparer organisation
Allianz	Germany	Preparer
IE – CFO Forum	Belgium	Preparer organisation
Ermelindo Varela	Belgium	Individual
Erste Bank	Austria	Preparer
ICAC	Spain	National Standard Setter
Draft 2	France	------