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Post-Implementation Review of IFRS 9 – EFRAG Secretariat recommendations

1 The objective of this paper is to reflect the EFRAG Secretariat recommendations to change the EFRAG draft comment letter relating to the *Post-Implementation Review of IFRS°9: Classification and Measurement,* following the feedback received from comment letters and additional outreach.

Structure of the paper

2 This comment letter analysis contains:

(a) Main positions in EFRAG's proposed final comment letter;

(b) EFRAG Secretariat recommendations.

Question to EFRAG Board and TEG

3 Do EFRAG Board and TEG members agree with EFRAG Secretariat's recommendations in *Appendix 1: EFRAG Secretariat recommendations*?

Appendix 1 – EFRAG Secretariat recommendations

Cover letter

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

4 Considering the feedback received from constituents, the EFRAG Secretariat suggests to:

(a) To remove the issue of supply chain financing from the letter, also to avoid overlap with EFRAG's draft comment letter on the IASB's Exposure Draft *2021/10 Supplier Finance Arrangements*;

(b) To remove the issues of modifications and financial guarantees from the letter;

(c) To lower the priority assigned to factoring of trade receivables to low.

5 The EFRAG Secretariat notes that EFRAG TEG has already discussed the issue relating to loan syndications and concluded that the complexity of a possible change would be high as it would put into question the impossibility to reclassify a financial instrument after its initial recognition. As a result, the EFRAG Secretariat suggests not to consider this point.

Question 1 – Classification and measurement

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.

EFRAG considers that on overall the classification and measurement requirements of IFRS 9 provide information that is useful for users to assess the amounts and timing of future cash flows.

Nevertheless, EFRAG suggests that the IASB addresses the issues of financial instruments with ESG features, measurement rules for equity and equity-type financial instruments, including a possibility for recycling for financial instruments measured at FVOCI the use of administrative rates, etc, which are described in detail in our responses to Questions 3 and 4.

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

6 Considering the feedback received from constituents, the EFRAG Secretariat suggests highlighting the following additional issues which need to be addressed by the IASB: measurement rules for equity and equity-type financial instruments, including a possibility of recycling option for financial instruments measured at FVOCI and refer for more details to Questions 3 and 4.

Question 2 – Business model for managing financial assets

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.

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

7 Considering the feedback received from constituents, the EFRAG Secretariat proposes not to make any changes to EFRAG tentative position.

8 The EFRAG Secretariat proposes to add the message that issues arise when applying the business model requirements under the COVID, on how to understand the requirements for permitted sales under the 'held to collect' business model. EFRAG would welcome more guidance in this area, but not as high priority topic.

9 The EFRAG Secretariat does not suggest undertaking standard setting to consider permitting reclassifications in circumstances other than those specified in paragraph B4.4.1 of IFRS 9.

Question 3 – Contractual cash flow characteristics

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.

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

10 The EFRAG Secretariat proposes to add the following messages:

(a) Note that differences exist in linking "E"-type features, "S"-type features and "G"-type features with credit risk;

(b) Suggest additional disclosures in providing information on financial instruments with ESG features;

(c) Developing the reasoning why financial instruments with ESG features should remain at amortised cost.

11 The EFRAG Secretariat further proposes to mention the difficulties that arise with the cash flow characteristics assessment with the following financial instruments:

(a) Sukuk investments which do not lead to interest payments as such, but provide similar cash flow streams; and

(b) Notes/bonds associated with certain emissions made through a special purpose vehicle within the framework of a supply-chain financing program of a corporate and which are backed by the suppliers' collection rights against the debtors.

12 The EFRAG Secretariat does not suggest referring to the Hungarian baby-boom loans, because of the leverage these instruments include, even if that leverage is determined at authority level.

Question 4 – Equity instruments and other comprehensive income

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. 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. 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.

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

13 The EFRAG Secretariat proposes to add the following messages:

(a) The need for recycling of equity instrument will increase when IFRS 17 is implemented;

(b) 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;

(c) 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;

(d) The feedback from the consultation of a disparity of treatment between debt and equity investments;

(e) The feedback from the consultation on proposed alternative scope of the equity-type definition; and

(f) Users that responded to this consultation consider that if realised gains or losses are not reflected in profit and loss, the performance of the equity portfolio might remain undisclosed as equity. This makes difficult to understand how equity has evolved over the period despite the statement of changes in equity and does not contribute to a good financial reporting.

14 The EFRAG Secretariat proposes to add a description for a comparable impairment model base on quantitative triggers such as:

(a) If 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 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.

Question 5 – Financial liabilities and own credit

EFRAG's tentative position

EFRAG is of the view that the requirements work as intended.

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

15 The EFRAG Secretariat acknowledges the comments received about the significant judgement involved in measuring the own credit spread and auditing the calculations, leading to difficulties of users to understand the rationale of the amounts held in OCI. Also, practical difficulties reported by a few constituents with the separation of the credit risk component. However, most constituents did not raise concerns with this requirement.

16 Considering the feedback received from constituents, the EFRAG Secretariat proposes not to make any changes to the draft response.

17 Further, paragraph 5.7.8 of IFRS 9 states that "If the requirements in paragraph 5.7.7 (to present the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability in OCI) would create or enlarge an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss". This, in EFRAG Secretariat view, addresses the concern expressed by the respondent.

Question 6 – Modifications to contractual cash flows

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, practice has now been established and EFRAG considers that there is no compelling case for standard setting.**

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

18 The EFRAG Secretariat notes that standard setting in this area is either not supported or indicated as not having high priority: the majority or respondents, including banking associations, do not support standard setting on this area (as practice has now been established by preparers), while some propose a narrow scope amendment (to explicitly extend to assets the treatment currently applied to liabilities), propose to deal with the difficulties of purchased or originated credit impaired financial assets or to clarify the interaction between impairment and modification.

19 The EFRAG Secretariat recommends informing the IASB about the diversity in practice and the additional issues collected in the consultation, however with a conclusion that there is no compelling case for standard setting.

Question 7 – Amortised cost and the effective interest method

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 Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

20 The EFRAG Secretariat proposes that the requirements of IFRS 9 paragraphs B5.4.5 and B5.4.6 are considered by the IASB, in particular to:

(a) Clarify the term "market rates of interest" in paragraph IFRS 9 paragraph B5.4.5;

(b) Provide qualitative indicators to differentiate between the application of IFRS°9 paragraphs B5.4.5 and B5.4.6.

21 The EFRAG Secretariat proposes to include feedback from constituents relating to different instruments for which the cash flow characteristics assessment is difficult.

Question 8 – Transition

EFRAG's tentative position

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

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

22 The EFRAG Secretariat has considered the comment that the continued transition disclosures are not useful. I.e. to disclose what the fair value of financial assets would have been for those instruments transferred at amortised cost. The EFRAG Secretariat notes that this disclosure (IFRS 7, paragraph 42M) comes with a sunset clause and therefore proposes not to incorporate this comment in the letter.

Question 9 – Other matters

EFRAG's tentative position

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 (deserving standard-setting activities) and financial guarantees (for which there is no compelling case for standard setting).

EFRAG Secretariat's recommendations to EFRAG Board and TEG on EFRAG's proposed final position

Own use contracts

23 The EFRAG Secretariat has considered the comment to further develop the requirements in IFRS 9 relating to own use contracts. For now, there is however

insufficient information to describe the issue allowing it to include it in the comment letter. The EFRAG Secretariat recalls that, in establishing paragraphs 2.4 to 2.7 of IFRS 9, the IASB deliberately did not follow the US GAAP treatment as this would, in the IASB's view, lead to an elective own use scope exemption (IFRS 9, BCZ2.31).

Energy contracts

24 The EFRAG Secretariat has considered the suggestions from two constituents regarding (two different types of) financial contracts often used in the renewable energy industry.

(a) Oversized contracts: the EFRAG Secretariat would like to receive further information on the costs of working with two units of account compared to the benefits the proposal offers.

(b) Virtual power purchase agreements: the EFRAG Secretariat notes that a change in accounting for one particular type of contracts would be rules-based and before being considered potential knock-on effects should be considered.

25 For these reasons, the EFRAG Secretariat proposes not to consider these proposals in the EFRAG comment letter.

Financial guarantees

26 On financial guarantees, the outcome of the consultation doesn't show a support for standard setting in this area: the majority of the respondents from the financial and insurance sectors are either silent or do not support a change. The EFRAG Secretariat recommends informing the IASB about the issue, however with a conclusion that there is no compelling case for standard setting.

27 In addition, the EFRAG Secretariat has considered the comment relating to the different accounting treatment of received and issued financial guarantees and the suggestion to align both. However, the EFRAG Secretariat notes that this could result in knock-on effects on other parts of IFRS 9 such as the application of paragraphs 4.1.1 to 4.1.5. of IFRS 9 to hybrid financial asset hosts. As these principles have not been questioned, the EFRAG Secretariat suggests not to incorporate this issue.