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IFRS in Focus

IASB seeks views on the post-implementation review of the IFRS 9 classification and measurement requirements

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This *IFRS in Focus* discusses the Request for Information *Post-implementation Review—IFRS 9 Financial Instruments—Classification and Measurement,* published by the International Accounting Standards Board (Board) in September 2021.

- The Board has published a Request for Information (RfI) seeking comments from stakeholders to identify:
  - Whether the classification and measurement requirements in IFRS 9 provide information that is useful to users of financial statements
  - Whether there are requirements that are difficult to implement and may prevent the consistent implementation of the Standard
  - Whether unexpected costs have arisen in connection with applying or enforcing the Standard
- The comment period ends on 28 January 2022

Background

IFRS 9 *Financial Instruments* became effective for annual periods beginning on or after 1 January 2018 and replaced IAS 39 *Financial Instruments: Recognition and Measurement.* IFRS 9 brought the following main improvements to financial instruments accounting:

- Classification and measurement requirements for financial assets that reflect the entity's business model and the asset's cash flow characteristics
- An expected credit loss model that results in more timely recognition of loan losses
- A hedge accounting model with a better link between the economics of risk management and its accounting treatment

The Board has started its post-implementation review (PIR) of IFRS 9, beginning with the classification and measurement requirements. The Board will seek feedback on the impairment requirements and hedge accounting requirements at a later time when more information is available about the effects of the application of those sections.

Questions for respondents

Classification and measurement

IFRS 9 provides a principles-based approach that aligns measurement with contractual cash flow characteristics of the financial assets and the way the entity manages them. The Board retained the IAS 39 classification and measurement requirements for financial liabilities substantially unchanged in IFRS 9 because feedback suggested that those requirements worked well.

The Board heard feedback from stakeholders that the changes to the classification and measurement requirements had little effect on their accounting for financial instruments. For example, many basic lending arrangements were measured at amortised cost applying IAS 39 and continue to be measured at amortised cost applying IFRS 9.

For more information please see the following websites:

www.iasplus.com

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The RfI asks whether the classification and measurement requirements in IFRS 9 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. It also asks whether the requirements result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows.

With this question, the Board is seeking 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.

Business model for managing financial assets
The 'business model' in IFRS 9 refers to how an entity manages its financial assets to generate cash flows, by collecting contractual cash flows, selling financial assets or both. The business model is typically observable through the entity's activities to achieve its business objective.

The RfI asks whether the business model assessment is working as intended by the Board, i.e. 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.

The RfI also asks whether the business model assessment can be applied consistently, i.e. 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.

The Board would also like to have information on whether there are any unexpected effects arising from the business model assessment, and if yes, how significant they are. The Board is particularly interested in 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.

Additional information request—Reclassification
IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes. These changes are expected to be rare.

The Board would like to understand in which situations and how frequently reclassifications have occurred. It would also be interested to know about situations in which a significant event has occurred but for which the conditions in IFRS 9 for a change in business model have not been met.

Contractual cash flow characteristics
Amortised cost is a simple measurement technique that allocates interest payments using the effective interest method over the life of a financial instrument. It 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 (FVTOCI), subject to the business model in which the asset is held.

The RfI asks whether the cash flow characteristics assessment is working as the Board intended, i.e. 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 respondents think that certain assets whose contractual cash flows fail the SPPI test should nonetheless be measured at amortised cost or FVTOCI, the Board would like to know why these assets' cash flows do not meet SPPI and which measurement approach could provide useful information in respondents' views. Respondents should also explain how the measurement approach would be applied.

The RfI also asks whether the cash flows characteristics assessment can be applied consistently, i.e. 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.

The Board would also like information as to whether there are any unexpected effects arising from the cash flow characteristics assessment and, if yes, how significant they are. The Board is particularly interested in 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.

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Additional information request—Financial instruments with sustainability-linked features
Recent market developments have given rise to an increase in financial instruments with contractual terms that relate to sustainability initiatives, indices or targets. In some cases, these terms can affect the contractual cash flows of the instrument. For example, the interest rate on a loan may vary depending on whether the borrower meets specified environmental, social and governance (ESG) targets.

The Board is seeking information about whether IFRS 9 provides sufficient guidance to enable entities to determine whether financial assets with sustainability-linked features have SPPI cash flows and whether applying the contractual cash flow characteristics assessment to those financial assets results in those assets being measured using an approach that provides users of financial statements with useful information about the amount, timing and uncertainty of future cash flows.

Additional information request—Contractually linked instruments
Some financial assets are structured in multiple tranches that create concentrations of credit risk. The payments on all tranches are contractually linked to payments on a pool of underlying instruments and the holders of each tranche have the contractual right to payments only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches. These financial assets are referred to as contractually linked instruments (or tranches). IFRS 9 requires the classification of such contractually linked instruments to be assessed based on the conditions at the date the holder initially recognised the instrument using a 'look-through' approach. Classification is based on the terms of the instrument (to determine whether it includes SPPI cash flows) and on an assessment of the pool of underlying instruments. This assessment considers the characteristics of the underlying instruments and the tranche's exposure to credit risk relative to the credit risk of the pool of underlying instruments.

The Board would like to understand the fact patterns to which the requirements for contractually linked instruments are being applied and the outcome of applying them. The Board also would like to understand whether IFRS 9 provides sufficient application guidance on contractually linked instruments, for example, on the scope of the financial assets to which the requirements apply. The Board would like to understand in what circumstances it is complex to assess whether a financial asset is a contractually linked instrument and why it is complex.

Equity instruments and other comprehensive income
Equity instruments do not have SPPI cash flows and are therefore measured at fair value through profit or loss (FVTPL). The Board decided that fair value provides the most useful information about the amount, timing and uncertainty of the cash flows arising from investments in equity instruments. 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.

Stakeholders hold mixed views on the prohibition of recycling gains and losses, and some are of the view that they should be reclassified to profit or loss on the disposal of the equity instruments. Stakeholders with that view have suggested in the past that the accounting treatment should maintain a distinction between realised and unrealised gains and losses. Some stakeholders suggest that without recycling of realised gains and losses on disposals, users of financial statements are provided with insufficient information about those disposals. In their view, this in turn could result in long-term investments in equity instruments being less attractive to entities.

The RfI asks whether the option to present fair value changes on investments in equity instruments in OCI is working as the Board intended, i.e. whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both equity instruments measured at FVTPL and equity instruments to which the OCI presentation option has been applied). For equity instruments to which the OCI presentation option has been applied, the Board would like to know 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 *Financial Instruments: Disclosures.*

The Board would also like to know for which equity instruments entities elect to present fair value changes in OCI. The Board particularly asks to 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.

The RfI also asks whether there are any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI and, if yes, how significant these are. Respondents are asked to explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions and to provide any available evidence which will enable the Board to understand the context and significance of the effects.

Financial liabilities and own credit
The fair value of an entity's own debt is affected by changes in the entity's own credit risk. 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). To address concerns about counterintuitive and confusing results for financial liabilities voluntarily designated at FVTPL, 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).

The RfI asks whether the requirements for presenting the effects of own credit in OCI are working as the Board intended and to explain whether the requirements, including the related disclosure requirements, achieved the Board's objective. In particular, the Board is interested in information as to whether the requirements capture the appropriate population of financial liabilities.

The Board would also like to know whether there are any other matters relating to financial liabilities that the Board should consider as part of the PIR.

Modifications to contractual cash flows
When contractual cash flows are renegotiated or otherwise modified, the modification could result in the entity derecognising or recalculating the carrying amount of the financial instrument. IFRS 9 does not define a 'modification' of a financial asset or financial liability. For financial assets, IFRS 9 refers to the modification or renegotiation of the contractual cash flows, while for financial liabilities it refers to the modification of the terms.

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

The RfI asks whether the requirements for modifications to contractual cash flows are working as the Board intended and what changes respondents consider to be modifications of a financial asset and modifications of a financial liability. The Board would like to know whether the application of the modification paragraphs and the disclosure requirements related to modifications result in useful information for users of financial statements.

The Board is also seeking information on whether the requirements for modifications to contractual cash flows can be applied consistently. Respondents are requested to 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. The Board is also interested in whether the requirements have been applied differently to financial assets and financial liabilities.

Amortised cost and the effective interest method
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. 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.

The RfI asks whether the effective interest method is working as the Board intended, i.e. 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.

The Board is also interested in whether the effective interest method can be applied consistently and seeks information on the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 or B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply.

Respondents should also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are.

Additional information request—Interest rates subject to conditions and estimating future cash flows
Recently, the Board has learned of differing views on and various questions about calculating the effective interest rate at initial recognition of a financial instrument and how to account for subsequent changes in estimates of cash flows. These questions relate to interest rates subject to conditions and to estimating future cash flows (for example, how to factor in changes in estimated cash flows including modifications).

The Board would like to understand whether the application guidance for the effective interest method enables consistent application of the method.

Transition

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.

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

- 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

- 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

- Were permitted but not required to present restated comparative information on initial application of the Standard

- Did not apply IFRS 9 to financial instruments derecognised before the date of initial application

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

The RfI asks whether the transition requirements worked as the Board intended, i.e. 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.

The Board would also like to know 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.

Respondents are also asked whether there were any unexpected effects of, or challenges with, applying the transition requirements and how those challenges were overcome.

Other matters

The Board asks stakeholders to share feedback on other matters relevant to the PIR, particularly with regard to whether the objectives of the standard-setting project have been met, whether the information provided by the Standard is useful to users of financial statements, whether the costs are as expected for preparing, auditing, enforcing or using the information entities provide when applying the Standard and whether the Standard can be applied consistently.

Considering the Board's approach to developing IFRS 9 in general, the RFI also asks for views on lessons learned that could provide helpful input to the Board's future standard-setting projects.

Comment period

The comment period for the RfI ends on 28 January 2022.

Further information

If you have any questions about the RfI, please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS in Focus*.

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