

28 January 2022

Andreas Barckow  
Chair  
International Accounting Standards Board  
Columbus Building  
7 Westferry Circus  
Canary Wharf  
London  
United Kingdom

Dear Dr Barckow

## Request for Information - Post-implementation Review IFRS 9 Financial Instruments Classification and Measurement

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ("the Board") Request for Information - *Post-implementation Review IFRS 9 Financial Instruments Classification and Measurement* ("the RFI").

We support the efforts of the Board to undertake a post-implementation review of IFRS 9 *Financial Instruments* ("the Standard" or "IFRS 9") and to consider in the first instance the classification and measurement requirements of the Standard.

We believe the classification and measurement requirements of IFRS 9 have generally worked well and as intended, leading to useful information for users of financial statements about the amount, timing and uncertainty of future cash flows. However, we believe there are areas that could be amended to improve the usefulness of information that arises from applying the Standard and to make the Standard more relevant given changes in lending activity that have developed since the classification and measurement requirements were finalised in 2014.

We believe the three main areas of the Standard that could benefit from amendments are:

- *ESG contractually linked variable debt*: Considering whether, and if so when, ESG-contractually linked variable debt could be measured other than as at fair value through profit or loss;
- *Amortised cost measurement model*: Strengthening the amortised cost measurement model with respect to distinguishing whether changes in forecast contractual cash flows are recognised immediately in profit or loss or via an adjustment to the effective interest rate, including how to reflect contingent cash flows as part of that forecast. We believe this is particularly important if the SPPI model for ESG contractually linked variable debt is amended to result in such debt instruments being measured other than as at fair value through profit or loss.
- *Contractually linked instruments*: Revisiting the requirements for contractually linked instruments and their interaction with the requirements for non-recourse financial assets.

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Our detailed responses to the questions in the RFI are included in the Appendix.

If you have any questions concerning our comments, please contact Andrew Spooner in London at +44 (0) 20 7007 0204.

Yours sincerely

A handwritten signature in grey ink, appearing to read 'V Poole', with a stylized flourish at the end.

**Veronica Poole**  
Global IFRS and Corporate Reporting Leader

## Appendix

### 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 amount, 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 respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

The classification and measurement requirements of IFRS 9 have generally allowed entities to classify and measure financial assets appropriately and, as a result, to provide useful information to users. The principles of the classification and measurement model are sufficiently clear to allow preparers to exercise judgement in arriving at appropriate classifications based on the characteristics of assets and the way in which those assets are managed in the business.

The changes in the classification and measurement principles introduced by IFRS 9 have required entities to make both instrument-level SPPI assessments and higher-level business model assessments to classify financial assets. The introduction of the SPPI assessment gave rise to auditing challenges compared to IAS 39. Indeed, although IAS 39 also required assessments of the terms and conditions of financial instruments at the instrument-level (e.g. to assess the criteria for embedded derivatives, loans and receivables and held to maturity instruments), IFRS 9 requires an assessment of specific aspects of the transaction for which the instrument was originated, for example when assessing a special purpose entity ('SPE') for contractually linked instruments. Similarly, IFRS 9 requires a wider analysis of the contractual terms of financial assets relative to the features of other instruments, for example when assessing the modified time value of money. Further challenges in applying IFRS 9 have arisen from interpreting the SPPI principle and applying the associated examples and rules to many different contractual arrangements.

The introduction of the business model assessment has required auditors to assess how entities manage financial assets. This was performed to a limited extent under IAS 39, for example to assess the criteria for held-for-trading instruments, but in such cases the business model was generally easier to assess compared to IFRS 9 which requires an assessment of the business model in more complex cases. This has introduced some challenges for both preparers and auditors because an entity's business model for managing financial assets is not an assertion or designation made by an entity for the purpose of accounting, rather it is an outcome of an assessment of the business activities that is subjective and is required to be made on a continuous basis.

We have identified some narrow issues in our response to Question 2 where we believe improvements to the business model assessment could be made.

## 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.

### (b) 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

### (c) Are there any unexpected effects arising from the business model assessment? How significant are these 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).

### (a) Is the business model assessment working as the Board intended?

We consider that generally the business model assessment has worked as the Board intended. However, there are two areas which frequently arise in practice that we believe would benefit from further consideration:

- The level at which an entity's business model assessment is made; and
- How to assess the collection of contractual cash flows in respect of financial assets that have been subject to a transfer as defined by IFRS 9:3.2.3(b) but have not been fully derecognised and conversely, how to assess collection of contractual cash flows when assets are not expected to be transferred but are expected to be subject to a substantial modification.

The level at which the business model should be assessed has presented some challenges because it is often possible to identify the management of the same assets at more than one level resulting in potential diversity in practice. For example, assets with specific characteristics may be identified to be "held to collect" cash flows but they may form part of a wider portfolio of assets managed at a higher level where there are more sales of assets with different characteristics resulting in a "hold to collect and sell" business model. This raises challenges about the level at which the business model should be assessed to present the most useful information to users.

Furthermore, once an entity has determined the level at which it assesses a business model for managing financial assets, the level of this assessment cannot be changed subsequently unless reclassification requirements of IFRS 9 are met. Assuming the reclassification requirements are not met, this may result in the retention of a business model classification for assets that remains supportable at the level it is assessed but is not necessarily the most appropriate for the assets held (i.e. a lower-level assessment may subsequently be deemed more appropriate but cannot be applied unless reclassification requirements are met). We expect such issues to reduce over time as preparers refine the level at which business models are assessed for newly originated/acquired assets. However,

such issues are expected to continue to arise, e.g. as part of internal business reorganisations and acquisitions where the requirements for reclassification are not met.

We observe that there can be changes in circumstances that have implications on how assets are managed after initial recognition. This may be the case, for instance, if an entity decides to enter into a factoring arrangement for existing trade receivables or if an entity has planned to syndicate a loan (or part of it) but fails to perform as anticipated when the business model assessment was made. In such changed circumstances, the business model previously determined no longer reflects of how financial instruments are actually managed. As these changes in circumstances are not rare, they do not meet the reclassification requirements are not met and the measurement of the assets cannot be changed. Given that the business model assessment was introduced to provide useful information to users of financial statements over how financial assets are managed and what their measurement attribute is, in the circumstances described, it is arguable whether this objective is met under the current requirements.

In our experience, reclassifications have been limited in practice. This may be partly influenced by the Board's expectation noted in IFRS 9 that changes of business model are expected to be rare. Because reclassifications are required, and not elective (as was the case with IAS 39), entities are required to monitor continuously whether business models have changed. In practice, we note that changes in business model normally arise from strategic decisions in response to an acquisition or merger of entities. Such decisions in respect of specific assets are not generally made at the date of acquisition but rather at some point after acquisition as businesses are aligned. As a result, the date of a change in business model is not always clear-cut

The second area we would recommend for clarification is how to assess the collection of contractual cash flows in respect of financial assets that have been subject to a transfer as defined by IFRS 9:3.2.3(b) but have not been fully derecognised, and conversely, how to assess the collection of contractual cash flows when assets are not expected to be transferred but are expected to be subject to substantial modification or exchange of financial instruments with substantially different terms.

It is common for entities to transfer financial assets and retain an economic interest in the transferred assets resulting in the assets not being fully derecognised (i.e. the assets continue to be fully recognised or are partly recognised to the extent of the transferor's continuing involvement). In many arrangements the transferor does not retain the right to collect contractual cash flows (either partly or fully during the remaining contractual life of the asset), yet the asset continues to be recognised either partly or fully. Given there is no derecognition of the asset in its entirety and no new financial asset to be recognised and assessed for the business model assessment and SPPI, a question arises as to how to assess the entity's business model given the transferred asset that continues to be recognised may not give the entity the right to collect the contractual cash flows. This question highlights that there is a potential difference between the business model assessment of holding assets to collect contractual cash flows, which presumes the entity has that legal right to collect the cash flows, and the derecognition requirements that can result in an entity continuing to recognise a transferred asset due to retention of risks and rewards of ownership without having the legal right to collect the asset's contractual cash flows. Two examples illustrate these two different concepts:

- An entity enters into a repurchase arrangement, a 'repo', of a debt instrument asset for part of the debt instrument's contractual life. For example, the entity sells a debt instrument with a remaining two-year maturity with a concurrent agreement with the buyer to buy back the debt instrument at a fixed price in six months. Substantially all the risks and rewards of ownership are retained because of the obligation to buy back the instrument at a fixed price, yet for six months the entity does not intend (or have the right) to collect the contractual

cash flows. Should the repurchase arrangement (although not recognised) affect whether the entity intends to “hold financial assets in order to collect contractual cash flows” in accordance with IFRS 9:4.1.2(a)?

- An entity enters into an arrangement in which it transfers debt instrument financial assets but writes a guarantee to the buyer whereby the entity agrees to compensate the buyer in cash for the first credit losses up to a specified amount. The credit guarantee written by the entity results in the transferor retaining substantially all the risks and rewards of ownership and continuing to recognise the transferred asset in full. The transferor is not acting as servicer such that all cash flows pass directly to the transferee. Should the written credit guarantee (although not recognised) affect whether the entity intends to “hold financial assets in order to collect contractual cash flows” in accordance with IFRS 9:4.1.2(a)?

In practice, we tend to observe entities considering the ‘held’ in ‘held to collect’ as continued recognition of the transferred financial asset as opposed to retaining the contractual rights to receive cash flows from the asset. Clarification in IFRS 9 as to whether this approach reflects the intent of the Board would be beneficial given the potential for diversity in practice.

Conversely, entities face scenarios where financial assets are not subject to transfer as defined by IFRS 9.3.2.3(b) but are subject to potential derecognition as a result of intended substantial modification (or exchange with original debtor for an instrument with substantially different terms). For example, a portfolio of financial assets is originated by an entity with an expectation, based on past experience, that some of the assets in the portfolio will undergo substantial modification of terms (or exchange of instruments) that can result in derecognition of the original financial assets and recognition of new financial assets. IFRS 9:B4.1.3A permits sales of financial assets in response to credit deterioration to be treated as not tainting the held to collect business model. We believe the Standard would benefit from clarifying that substantial modifications or exchanges of an instrument with the original debtor for an instrument with substantially different terms would also not taint the held to collect business model if such modifications or exchanges are in response to credit deterioration.

## **(b) Can the business model assessment be applied consistently?**

Establishing whether the business model assessment is being applied consistently is challenging given the number of potential business models. However, broadly speaking, we believe that the business models described in IFRS 9 to determine classification are sufficiently distinct to allow preparers to form their judgement as to how their business models fit with the models described in the Standard. Our experience does not extend to insurers since most insurers have chosen to defer the application of IFRS 9 until IFRS 17 is applied.

An area of potential inconsistency in the application of the business model assessment is the level at which the business model is assessed. In November 2016, the IFRS Interpretations Committee discussed a request to clarify how a reporting entity applies the business model assessment in its consolidated financial statements when a subsidiary is classified as held for sale applying IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Specifically, the Committee discussed whether a reporting entity considers the financial assets of a subsidiary to be within a ‘hold-to-collect’ business model or a ‘hold-to-sell’ business model if the subsidiary holds the financial assets to collect contractual cash flows and is also classified as held for sale applying IFRS 5. Based on the analysis set out in the agenda paper presented, the staff was of the view that, in its consolidated financial statements, a reporting entity performs the assessments required by IFRS 9 from a group perspective rather than the subsidiary’s perspective. However, no further action was taken by the Committee or the Board with respect to this issue.

Our published guidance supports a business model assessment at the subsidiary level. In our view, the intention and/or decision to sell a subsidiary does not in itself represent a change in business model because the activities of the subsidiary following a decision to sell remain the same (i.e. unless a decision is made post sale, the subsidiary would continue to originate assets and service those assets with the aim of collecting the cash flows as opposed to realising a profit through selling or trading the assets). IFRS 9 refers to "managing the financial assets" and it is at the subsidiary level that the assets continue to be managed to collect the contractual cash flows. We are aware that other preparers and auditors also support this view. Given the initial IFRS Interpretations Committee discussion was not finalised, there may be diversity practice in respect of this issue. It would be an area worthy of consideration in terms of potentially supplementing the current guidance in IFRS 9, including considering whether there is a need to draw a distinction between this case and the current example in IFRS 9.B4.4.1(b). We also note that there were other implications of the IFRS Interpretations Committee deliberation, such as the implication on cash flow hedge accounting. We suggest that the Board may also want to consider addressing this aspect as part of the PIR on hedge accounting.

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

On adoption of IFRS 9 there were limited unexpected effects arising from the business model assessment except in relation to trade receivables. Under IAS 39, basic trade receivables were generally classified at amortised cost and their classification was not identified by preparers or users as inappropriate or in need of reform. Consequently, the application of the IFRS 9 business model requirements to classify certain factored trade receivables at fair value was unexpected by certain corporate entities on adoption of IFRS 9.

On adoption of IFRS 9, a number of entities were required to classify portfolios of trade receivables as held to collect and sell (FVTOCI) or held to sell (FVTPL) because they were subject to debt factoring arrangements that can lead to derecognition of the trade receivables such that trade receivables do not meet the held to collect (amortised cost) business model. Trade receivables without a significant financing component are recognised under IFRS 9 at their transaction price as determined by IFRS 15 *Revenue from Contracts with Customers*. Given the short-term nature of such trade receivables, the exception to recognise them at their transaction price on initial recognition, as opposed to their fair value, and the fact that actual sales would be recognised within a short time after recognition, we question whether the costs of performing and auditing a business model assessment and determining fair values for trade receivables outweighs the benefits of subsequently measuring such assets at fair value. The application of the business model assessment to trade receivables without a financing component was not explicitly considered by the Board when the IFRS 9 classification and measurement model was developed and could be seen to be an unintended consequence of the model which would benefit from being revisited.

Another area where IFRS 15 and IFRS 9 interact, and classification of financial asset questions arise, is on the classification of receivables that are subject to a potential rebate based on the volume of future sales. Entities may offer retrospective rebates when a customer reaches a specific volume threshold with the rebate forming part of variable consideration in a contract and so considered in determining the transaction price under IFRS 15. To recognise the receivable, the entity needs to determine the amount of consideration that is unconditional, which is the invoiced amount that is due before the customer is expected to meet the conditions for the rebate. Hence the seller of goods or services determines that it has an unconditional right to the consideration before the rebate is granted. In this case, the entity recognises a receivable at the full amount, although the customer is expected to give a refund in the future. In this scenario, the transaction price differs from the amount

of the receivable, yet IFRS 9:5.1.13 does not seem to envisage scenarios in which this can arise as it states that an entity shall measure trade receivables that do not have a significant financing component (determined in accordance with IFRS 15) at their transaction price (as defined in IFRS 15). IFRS 9:5.13 could benefit from being amended to acknowledge that the amount of the receivables can be different to the transaction price based on the requirements of IFRS 15.

**Question 3 – Contractual cash flows characteristics****(a) Is the cash flow characteristics 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).

**(a) Is the cash flow characteristics assessment working as the Board intended?**

We are generally supportive of the need for a cash flow characteristics assessment to identify financial assets for which useful information cannot be reasonably provided unless they are measured at fair value through profit or loss (FVTPL). In practice, the application of the cash flow characteristics assessment, 'the SPPI assessment', to certain types of instruments has raised concerns. These



instruments are contractually linked instruments, non-recourse financial assets, ESG-contractually linked debt, in particular the application of the de minimis test to these instruments.

### *Contractually linked instruments and non-recourse financial assets*

Under the SPPI assessment, when a creditor's claim is limited to specified assets, e.g. a non-recourse financial asset or contractually linked instrument (CLI), an additional assessment, over and above an assessment of the contractual interest and principal amounts of the asset, is required. This is to determine whether the terms of the financial asset give rise to other cash flows or limits the cash flows in a manner that is inconsistent with payments representing principal and interest. Under the IFRS 9 classification and measurement model, the SPPI assessment requirements for a non-recourse financial asset are different from the requirements for a CLI. The criteria for a CLI to have cash flow characteristics that are payments of principal and interest are stricter than the equivalent criteria for non-contractually linked non-recourse financial assets. For example, a CLI issued by a SPE that invests in non-financial assets cannot meet the SPPI requirements, whereas a non-CLI non-recourse asset collateralised by a non-financial asset may. Consequently, a CLI may be required to be measured at FVTPL because it fails the SPPI requirements whereas a non-recourse financial asset with an equivalent cash flow profile would pass the SPPI requirements.

Consider the example of a SPE that invests CU100m in finance lease assets with fixed repayment amounts that includes substantive residual value risk arising from the option for lessees to return the assets at the end of the term of the lease. Assume that the variability from the residual value risk represents up to CU10m of the value of the lease portfolio. Under Scenario 1, the SPE issues two tranches of contractually linked instruments. A senior Tranche A is issued for CU60 and a junior Tranche B is issued for CU40. Under Scenario 2, the SPE is funded by a combination a loan (CU60) and issued equity (CU40), where the cash flows of the loan are identical to the cash flows of Tranche A in Scenario 1. Under Scenario 1, the investment in Tranche A is required to be measured at FVTPL because the underlying pool of financial instruments does not meet the contractual cash flow characteristics of IFRS 9:B4.1.23 and B4.1.24. However, under Scenario 2 the investment in the loan is expected to meet the SPPI requirements because there is no contractual linkage and the non-recourse guidance applies when the issued equity is sufficient to absorb any variability from the residual value risk.

In these situations, where the senior tranche of a CLI structure will not be affected by the non-SPPI cash flows of the underlying pool, classification of the investment at FVTPL when it is held to collect the contractual cash flows (or held to collect and sell) does not provide the most useful information to users and is inconsistent with the classification of non-contractually linked non-recourse assets with equivalent cash flows.

One way to address this inconsistency would be to extend the de minimis assessment noted in IFRS 9:B4.1.25 in respect of assessing whether assets within the pool meet the SPPI requirements to the assessment of the effect of assets within the pool on the cash flows of the issued CLIs, i.e. if the underlying pool contains assets that do not meet the requirements in IFRS 9:B4.1.23 and B4.1.24 but the cash flows from those assets have no, or a de minimis, effect on the cash flows of a CLI tranche that meets the conditions in IFRS 9:B4.1.21(a) and (c), that tranche should be considered to have cash flows of principal and interest.

### *ESG-contractually linked debt*

The RFI of IFRS 9 is timely given the exponential growth in ESG-linked debt, both lent and borrowed by IFRS reporting entities, which is expected to continue. We welcome the Board explicitly acknowledging

this area in the RFI and requesting views since this type of lending was not as significant when IFRS 9 was developed.

As acknowledged by the staff in the agenda paper of July 2021 Board meeting, when a debt instrument has contractual cash flow variability linked to specified ESG-variables it will likely fail the SPPI test and will be required to be classified as at FVTPL by entities holding the debt instrument as an asset. Without changes to IFRS 9, we expect an increasing amount of financial assets being classified as at FVTPL.

In our response, we refer to ‘ESG-contractually linked variable debt’ to distinguish between fixed and variable debt instruments that may be used to fund ESG projects that may pass the SPPI assessment in IFRS 9 as their contractual cash flows do not vary based on ESG variables, and debt instruments with contractual variability linked to ESG variables that are therefore likely to fail the SPPI assessment.

To assess whether IFRS 9 should be amended in respect of ESG-contractually linked variable debt, we believe the following questions need to be answered: is a classification category other than FVTPL capable of capturing the cash flow variability from such debt arrangements? If yes, considering that cash flow variability can exist in many arrangements other than ESG-contractually linked debt, is it possible to develop guidance that is capable of distinguishing between debt arrangements that should be measured other than as at FVTPL and those that should be at FVTPL?

In answering the first question, we believe it is important to consider that, in our experience, issuers of ESG-contractually linked debt are not classifying their issued debt as at FVTPL. This reflects the fact that the debt is not held-for-trading and that the issuers often chose, as an accounting policy, to define “non-financial variable[s] specific to a party to the contract” in the definition of a derivative as not being limited to the definition of insurance risk, i.e. including non-financial variables such as ESG-variables. Consequently, issuers are generally accounting for ESG-contractually linked variable debt at amortised cost without separation of embedded derivatives for the ESG-linkage.

Amortised cost is capable of accounting for cash flow variability, including when that cash flow variability does not reflect changes in market interest rates. IFRS 9:B5.4.6 has specific measurement requirements for accounting for the change in expectations of contractual cash flows. Broadly, IFRS 9 requires the cash flows to be forecast and discounted by the original effective interest rate. We therefore believe IFRS 9 is capable of accounting for cash flow variability other than for changes in market interest rate in a measurement model other than FVTPL. This measurement model is currently applied for issuers of ESG-contractually linked variable debt, and we therefore think that such a measurement model is capable of being applied by lenders and investors of ESG-contractually linked variable debt (assuming the relevant business model assessment is also passed). As acknowledged in our response to Question 7, we believe that amortised cost measurement in IFRS 9 could be strengthened, specifically the application of IFRS 9:B5.4.6 in the case of contingent cash flows.

Improvements in this area would not be limited to ESG-contractually linked variable debt given contingent cash flows are common in many debt arrangements with prepayment options, debt where cash flows are linked to non-ESG variables such as revenue and profit where embedded derivatives are not separated. As has been noted by the IFRS Interpretations Committee in June 2021 as part of its analysis of the accounting for TLTRO-III, the requirements on how to forecast future contractual cash flow variability where cash flows are contingent on future events could be improved. Given ESG-variables in an ESG-contractually linked variable debt are contingent cash flows, we would support improvements to the application of IFRS 9:B5.4.6 if the Board were to consider developing a model for measuring ESG-contractually linked variable debt for lenders and investors at other than FVTPL.

The second question to answer in developing an alternative approach to ESG-contractually linked variable debt is whether it is possible to distinguish ESG-linked variability from other non-ESG variability where the latter should be required to be measured at FVTPL. We consider this question to be challenging given there is no common definition of ESG-linked variability. One proposal we have considered is to use the same definitions that are currently used by issuers of ESG-contractually linked variable debt in assessing whether ESG-contractually linked variable debt has embedded derivatives that require separation. Under IFRS 9, for issuers of ESG-contractually linked variable debt, consideration is given as to whether the ESG-variable meets part (a) of the definition of a derivative, specifically, whether the variable is a “non-financial variable specific to the party to the contract”. Practice has developed as to application of these words to many different variables. Given ESG-variables are generally designed to be specific to the borrower to incentivise (or disincentivise) its actions through lower or higher interest costs, we believe the use of such terminology has merit. For example, where interest costs of debt vary based on whether the issuer meets or does not meet specified Co2 emission targets, the non-financial variable, the Co2 emissions, would be specific to a party to the contract, in this case the issuer’s emission targets. If the ESG-variability is a non-financial variable, such as Co2 emissions, but it is not specific to a party to the contract (e.g. if it is based on global Co2 emissions rather than emissions of the borrower) then such ESG-variability would not be specific to the borrower. Using existing definitions that have already been applied for issuers of ESG-contractually linked variable debt to lenders and investors has the attractiveness of allowing the same amortised cost measurement for both issuer and lender subject to the lender meeting the business model assessment already in IFRS 9. Using such a definition would ensure that other cash flow variability that passes the definition of a derivative, such as linkage to equity prices, bond prices, commodity prices, other financial indices and non-financial variables not specific to a party to the contract, would continue to fail the SPPI assessment and therefore would be appropriately measured at FVTPL.

We acknowledge that developing a model based on the term ‘non-financial variable specific to a party to the contract’ has the potential to scope in non-financial variables that are not ESG-based, for example debt or other preference shares/notes that are financial liabilities where the amount of interest payable by the issuer is a function of the profits of the issuer, i.e. a profit participatory note. In practice, many entities regard profits of the issuer as a non-financial variable and therefore do not separate out embedded derivatives and instead apply the amortised cost requirements of IFRS 9:B5.4.6. The question for consideration by the Board should they consider such an approach, is whether those financial assets should be scoped into being capable of measurement at amortised cost given the difficulty in distinguishing ESG-based non-financial variables that are specific to a party to the contract from those non-ESG-based variables. On balance, given the difficulty in defining ESG-based variability, particularly in a market that is constantly developing, we believe the scope of including financial assets with variability that is based on a non-financial variable specific to the party to the contract as passing the SPPI assessment may need to be kept broad. As mentioned previously, we believe such an approach has merit if the measurement requirements of IFRS 9:B5.4.6 are strengthened to accommodate the increasing amount of assets that would fall within its scope.

Lastly, should the Board consider our proposal of using the term ‘non-financial variable specific to a party to the contract’ as a way of distinguishing debt instruments, we believe that Board should also consider providing more guidance as to what a non-financial variable. Indeed, given the broader scope of instruments that may be affected, this would promote consistent accounting for financial assets for which this term would now apply. It would also promote consistency with the accounting for financial liabilities where the term is currently being applied when entities assess whether variables meet part

(a) of the definition of a derivative in assessing whether such features are potentially separated out as embedded derivatives.

**(b) Can the cash flow characteristics assessment be applied consistently?**

Since adoption of IFRS 9 the requirements for assessing the contractual cash flow characteristics of financial assets have been generally consistently applied. Some aspects have required judgement to be applied (e.g. in respect of increased cost clauses, prepayment options, etc) which in our experience has been applied reasonably to arrive at appropriate conclusions.

**(c) Are there any unexpected effects arising from the cash flow characteristics assessment?**

We have not identified any unexpected effects from the contractual cash flow assessment other than those outlined above.

**Question 4—Equity instruments and other comprehensive income**

**(a) Is the option to present fair value changes on investments in equity instruments in OCI 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 OCI?**

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 OCI? 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).

The prevalence of investments in equity instruments and the use of the OCI election varies considerably across industry and geography.

In the investment funds sector, it is common for equity instruments and other financial securities to be measured at FVTPL, often because the capital (units) issued are often measured on the same basis and therefore recognition of gains/losses in profit or loss is more meaningful. Consequently, the introduction of the FVTOCI election for equity instruments has had little impact to that sector.

Whilst non-financial corporates are less likely to hold equity instruments, when they hold such instruments it is more likely to be for the longer-term. In this sector, we see mixed practice as to whether the FVTOCI is elected or the default accounting of FVTPL applied. The choice depends partly on the

preparers' approach to communicating the financial performance in OCI including their use of APMs, the weight a preparer places on the importance of recycling, the expected volatility of the equity security, and the additional disclosures required by IFRS 7, should the FVTOCI election be applied.

The insurance sector has largely not applied IFRS 9 given the ability to defer adoption of IFRS 9 until the adoption of IFRS 17. It is therefore not clear to what extent the FVTOCI election will be applied in that sector. However, given the extent to which equity instruments are invested to fund insurance liabilities (including index-linked insurance and other investment contracts) we consider the attractiveness the FVTOCI to be limited given the accounting mismatches that can arise. Given most insurers have not applied IFRS 9 we believe it is too early to say whether the insurance sector will be a significant user of the FVTOCI election, and irrespective of whether they use the election, whether the combination of IFRS 9 accounting for the asset and IFRS 17 accounting for the liabilities will result in information that could be improved had the IFRS 9 FVTOCI election differed. The Board may consider whether the topic would be better addressed as part of the PIR of IFRS 17 rather than amending IFRS 9 should it be judged that the accounting mismatches arise mostly from the interaction of IFRS 17 and IFRS 9, rather than IFRS 9 alone.

With respect to the qualifying criteria for the FVTOCI election, it would be beneficial if IFRS 9 was clearer in the authoritative part of the Standard that financial liabilities that meet the exception to be presented as equity for the issuer in accordance with the requirements of IAS 32:16A-D are not eligible for designation as at FVTOCI for the holder as explained in the Basis of Conclusions. Explicit consideration of this point including the reason for any lack of symmetry would be beneficial for preparers and auditors.

#### **Question 5— Financial liabilities and own credit**

**(a) Are the requirements for presenting the effects of own credit in OCI 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)?**

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

We believe the presentation of the effects of own credit in OCI is working as the Board intended. However, in practice, determining the separation of own credit from other market risks has been challenging for some issuers. As a result, it is common for entities to apply the practical expedient in IFRS 9:B5.7.18.

Other matters relating to financial liability accounting that most frequently arise are (i) the distinction of whether the liability in supplier finance arrangement is a trade or other payable, and (ii) whether a liability is presented as current/non-current when debt covenants depend on future contingent events. We note that both these areas are being dealt by the Board as part of separate projects. However, we encourage the Board to consider cross-cutting issues between these projects and the PIR on IFRS 9, namely the interaction between supplier finance arrangements and the assessment of whether the modifications to the contractual terms are substantial leading to derecognition, particularly when assessing qualitative changes in the terms and conditions (see our response to Question 6).

**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.

We note that across IFRS Standards the accounting for the effects of contract modifications varies considerably and there is a lack of an overarching principle as to when contractual modifications lead to derecognition, and if not, there is no derecognition how a gain or loss is recognised. These differences are not limited to those items in the scope of IFRS 9, but financial instruments outside the scope of IFRS 9 such as leases, share-based payment arrangements and insurance contracts, as well as non-financial instruments such as revenue arrangements. In the long-term, IFRS Standards would benefit from an overarching principle in this area given the similarity in many of these contractual arrangements.

In applying IFRS 9, we observe more consistency in the modification (failed derecognition) accounting outcomes for financial liabilities than for financial assets. This reflects the fact that there is more specific guidance on determining whether a financial liability modification is substantial (IFRS 9:3.3.2 and 10% test in IFRS 9:B3.3.6). We do not see a good basis for having different requirements for financial assets and financial liabilities, other than the specific impairment aspects that relate only to financial assets. To improve consistency the Board could consider whether the guidance can be aligned and whether the fact some contracts are modified in response to credit impairment, as opposed to not credit related events, should result in a different approach to assessing modification and derecognition.

For financial assets, IFRS 9:5.4.3 is less specific than the comparable guidance for financial liabilities. This has led to a variety of accounting policies, specifically for lenders. This is particularly important given lenders have different accounting policies to determine whether forbearance activities result in derecognition, including whether the 10% test is applied for financial assets by analogy to financial liabilities. Given the importance of forbearance activities, particularly in times of economic stress, we believe IFRS 9 should have more specific guidance on this to ensure that lenders apply more consistent accounting policies in respect of their forbearance activities.

In determining whether the modification of a financial asset is substantial, questions arise whether this should be a comparison of the modified contractual cash flows with the original unmodified contractual cash flows, specifically whether those unmodified cash flows should be adjusted to reflect post-write off cash flows (given IFRS 9 regards them as derecognised even though they are not contractually forgiven) or some other credit-modified cash flows. We believe the comparison should reflect post-write off cash flows but believe the Standard would benefit from clarity in this area.



When considering the modification requirements for financial liabilities (which are often also applied to financial assets by analogy), we believe there is limited guidance on the relative weighting that should be given to qualitative and quantitative factors in forming the judgement over whether the modification is substantial. If an entity performs the 10% test, i.e. a quantitative test, and determines that the present value difference is less than 10%, it is not clear whether the entity can nevertheless conclude that the modification is substantial based on qualitative differences in the pre and post modified cash flows. It is also not clear whether the qualitative and quantitative tests should be performed in a specific order. Views vary as to the relative weighting of a qualitative assessment and what qualitative characteristics should be considered. Given it is common for preparers to consider qualitative factors in assessing whether terms are substantially different for financial liabilities, guidance in this area would be beneficial to achieve more consistent accounting outcomes for both financial assets and financial liabilities. As noted in our response to Question 5, one area where guidance on qualitative factors may be particularly helpful is the area of assessing derecognition for supplier finance arrangements.

Another area where difficulties frequently arise in practice is the determination of the unit of account to be used in assessing whether terms are substantially different, including the application of the 10% test. It is common in loan syndications to have to changes in the lenders at the same time as cash flows are modified. The Standard does not provide guidance to assess at which level the test should be performed, at the lender level or the syndicate level, for example, whether the change in lender is a derecognition in isolation for some of the debt with other modifications being assessed separately, or whether the assessment considers all changes together. We have observed diversity in practice in assessing modifications and derecognition in this area.

We also note that there is a lack of guidance on how to determine whether a modification is substantial when prepayment options are introduced, taken away, or amended. In such cases, there are numerous scenarios that impact the timing of the pre and post modified cash flows but no guidance as to which scenarios should be included in the assessment, for example, the mostly likely timing of cash flows, or the cash flows that create the largest difference in timing and amount. Similarly, where prepayment options at par exist, and the debt is then modified, it is not clear whether the existence of the prepayment option should be considered as an in-substance prepayment of the debt and a lending of new debt (given the borrower has the right to repay and borrow at on-market terms) or as a modification of the existing arrangement. This is particularly relevant where the modification arises close to the date when the prepayment option could be exercised. Clarification on this point would reduce diversity.

The recent deliberations on the interest rate benchmark reform also highlighted that there is very little guidance to assist with the determination of whether modifications to derivatives lead to their derecognition. Even though the measurement outcome of whether a derivative is derecognised is of little consequence given derivatives are measured at FVTPL, this assessment remains an important unresolved issue following the recent IFRS 9 amendments because the derecognition conclusion determines whether hedge accounting ceases. The difficulty in assessing derecognition for derivatives arises because determining whether the modified terms are substantially different, often assessed using the 10% test, is challenging when derivatives have both an inflow and outflow and also are not discounted for measurement purposes using the original EIR (which the 10% test requires). This illustrates that the 10% test was originally designed for assessing derecognition of debt, not derivatives.

The deliberations on the interest rate benchmark reform also highlighted that there may be differing views between the Board and what we observe in practice as to the scope of modifications. In practice we observe that modifications are generally limited to changes in contractual terms resulting from bilateral agreement to change the terms and conditions of the contractual arrangement. In practice, changes to the underlying calculation of indices by the agency that governs the calculation, such as Government

agencies changing the calculation of inflation, where such indices are used as a basis for contractual cash flows, are not considered modifications. However, in the Board's deliberations on accounting for the interest rate benchmark reform some expressed a view that such changes are modifications. We observe in practice that such changes in underlying calculations are not modifications and so consequently generally see consistency in this area. If the Board were to be explicit that changes to the calculation of an index are contractual modifications then determining whether such a change should be accounted for in accordance with IFRS 9:B5.4.5 (prospective) or IFRS 9:B5.4.6 (cumulative catch up) would be critical. Our comments on the distinction between IFRS 9:B5.4.5 and B5.4.6 are included in more detail in our response to Question 7.

## 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).

The accounting for the effective interest rate method and amortised cost has been largely unchanged since IAS 39 was introduced, with IFRS 9 retaining the same requirements. Over that period, the distinction as to whether paragraph B5.4.5 of IFRS 9 (IAS 39:AG7) or paragraph B5.4.6 of IFRS 9 (IAS 39:AG8) applies has been one of the most challenging and interpretative areas of financial instruments accounting.

These challenges have been illustrated most recently with the IFRS Interpretations Committee's deliberations on the accounting for TLTRO-III. In addition, the IFRS Interpretations Committee in July 2008 considered whether inflation, in the case of inflation-linked debt, is a market rate of interest such that IAS 39:AG7 should be applied rather than AG8, but was unable to conclude, thus the Committee referred the matter to the Board. The issue remains unresolved.

The consequence of the lack of guidance, and a lack of clear principle as to why some adjustments to contractual cash flows are accounted for prospectively (B5.4.5) whilst other are accounted with a cumulative catch-up (B5.4.6), has led to a widespread number of accounting policies developed by preparers and accepted by auditors. We would welcome a more clearly defined principle along with guidance that illustrates that principle to common fact patterns with the objective of improving consistency and clarity in the Standard.

In practice, preparers and auditors spend significant time in this area considering whether variability in cash flows is a market rate of interest. In many cases, the conclusion may be clear if the debt is referenced to well established benchmark interest rates. However, the interest rate on many lending arrangements is



not referenced this way, as was illustrated with the IFRS Interpretations Committee's deliberations on the accounting for TLTRO-III. Central Banks have reference rates that are only available to certain market participants in which the Central Bank often has the unilateral right to change the interest rate. Similarly, many banks offer variable interest rates to borrowers that are an internally generated interest rate, such as a standard variable rate, SVR, where the rate is unique to loans that the bank originates. It is common for instruments with interest rates linked to Central Bank rates and SVRs that the borrower has the right to repay the borrowing without penalty. These prepayment rights support the notion that such rates are market rates of interest, and therefore B5.4.5 applies, given the borrower has the right to borrow from elsewhere and settle its loan at nil prepayment cost should the variable market rate be preferable elsewhere.

Questions also arise as to whether inflation-linked debt includes a market-based rate of interest. Generally, we see most preparers account for changes in inflation using B5.4.5 given they regard current changes in the inflation index as the market rate for servicing the debt. Questions also arise where interest is linked to non-financial variables where embedded derivatives are not separated, such as adjustments to interest linked to the borrower's revenue. Applying B4.5.6 would lead to significant volatility in P&L from present valuing future inflation curves or revenue estimations for future periods which in some cases are highly subjective and are not generally regarded as being relevant to current financial performance in the period.

We propose that the Board focuses on the conceptual question of the type of interest changes that should be accounting for prospectively (as in B5.4.5), with the remaining contractual variability being accounted for on a cumulative catch-up basis (as in B5.4.6). This approach would be easier than trying to describe what variables should be in the scope of B5.4.6. Such an approach would give the Board license to consider more broadly variables other than traditional benchmark interest rates, such as inflation and ESG-variables.

As noted in our response to Question 3, should the Board consider amendments that would result in holdings of ESG-contractually linked variable debt being measured other than as at FVTPL, then the distinction between B5.4.5 and B5.4.6 would become even more important due to the increased application of the effective interest rate method to such assets.

Additionally, it is not clear how an entity should reflect contingent cash flows as part of the forecasting of contractual cash flows. This was also highlighted by the IFRS Interpretation's Committee deliberations on TLTRO-III. It is common when applying B5.4.6 for a debt arrangement to have cash flows where the amount and/or timing is contingent on future events. This includes prepayment options (where the amount is fixed but the timing is not, or where the timing and amount is not fixed), as well as increases or reductions in cash flows that are contingent on future events, such as was evidenced with TLTRO-III, where cash flows were linked to the borrower's lending volume. IFRS 9 (like IAS 39 that preceded it) does not have guidance as to how to assess whether such forecasts should be included as part of the discounted cash flow calculation, specifically what threshold preparers should apply in including such cash flows, and whether forecasts should be based on spot or forward rates. With respect to thresholds, we see a variety of approaches from simple methods such as only considering the most likely outcome, to more complex methods such as multiple scenario probability weighted outcomes. We believe the Standard would benefit from clarity in this area, particularly if the Board was to consider widening amortised cost measurement to ESG-contractually linked variable debt as we suggest in our response to Question 3.

## 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?

The transition requirements worked largely as the Board intended. The relief from restating comparatives was welcome.

One area of transition that was less favourable was the inability to restate comparatives fully because of the prohibition to restate items derecognised in the comparative period. For some entities, this made the option to restate comparatives less attractive thereby resulting in more entities not restating comparative at all. We note the Board has acknowledged this issue in their recent amendments to IFRS 9 in respect of insurers that are applying IFRS 17 and IFRS 9 for the first time.

## 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?

In 2007, the IFRS Interpretations Committee considered the application of IAS 39:11A, specifically whether it is possible for an entity to apply the fair value option for a contract where the host contract is outside the scope of IAS 39 on the basis the hybrid contracts contain an embedded derivative. At the time, the IFRS Interpretations Committee asked the Board to amend IAS 39 to replace the term 'contract' with the term 'financial instrument in the scope of IAS 39' to clarify that paragraph 11A applies only to financial instruments in the scope of IAS 39 that contain embedded derivatives [IASB Update December 2007]. Such a change would make clear that host contracts not accounted for under IAS 39 would not be eligible for the fair value option. However, the Board did not make the change to IAS 39 as part of its Annual Improvements projects nor as part of the finalisation of IFRS 9.

We supported the intent of the amendment proposed as part of the 2008 Exposure Draft on Improvements to IFRSs and we consider the issue still relevant under IFRS 9 given the fair value option available in IFRS 9:4.3.5 (the equivalent of IAS 39:11A in IFRS 9). Some consider IFRS 9:4.3.5 can be read as permitting the fair value option to be applied to all contracts that are not financial assets in the scope of IFRS 9 (irrespective of the scope paragraphs of IFRS 9:2.1 to 2.7). To address this, we propose IFRS 9:4.3.5 is amended as follows:

“Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is ~~not an asset~~ a financial liability within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:”

The proposed reference to ‘financial liability’ instead of ‘financial instruments’ reflects that IFRS 9 specifically scopes out financial asset host contracts from the assessment of embedded derivative (which was not the case in IAS 39).