Australian Government

Australian Accounting Standards Board

Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600

Dr Andreas Barckow
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf, London E14 4HD
UNITED KINGDOM
(submitted via the IASB website)

28 January 2022

Dear Dr Barckow,

AASB submission on IASB Request for Information on Post-implementation Review of the classification and measurement requirements of IFRS 9 *Financial Instruments*

The Australian Accounting Standards Board (AASB) is pleased to have the opportunity to provide comments on the International Accounting Standards Board (IASB) Request for Information on Post-implementation Review of the classification and measurement requirements of IFRS 9 *Financial Instruments* issued in September 2021.

In formulating these comments, the views of Australian stakeholders were sought and considered. This consultation included the receipt of three written submissions and the following outreach activities to gather views from stakeholders:

(a) AASB Financial Instruments Project Advisory Panel

(b) AASB User Advisory Committee

(c) AASB Academic Advisory Panel meeting

(d) other targeted consultations, including financial statement preparers, auditors, professional bodies, regulators, academics, and users.

The AASB acknowledges the efforts of the IASB to assess the effect on stakeholders of the new classification and measurement requirements in IFRS 9 and identify lessons learned that could be helpful for future standard-setting projects.

Overall, our stakeholders have indicated that the classification and measurement requirements of IFRS 9 are working as intended and provide useful information to users. However, as discussed in detail in the Appendix to this letter, we highlight the following matters:

(a) In respect of loans with sustainability linked features, we think it is important for the IASB to provide additional guidance around when such loans would be 'basic lending arrangements' and how to apply the SPPI test (Question 3).

(b) We support further work on presenting fair value changes of investments in equity instruments in other comprehensive income (OCI) including underlying principles and the issue of OCI and recycling more broadly (Question 4).

(c) We recommend further standard setting or application guidance on the related topics of derecognition, continuing involvement and modifications (Questions 6, 7 and 9).

The detailed recommendations and responses to the specific questions for respondents are in the Appendix to this letter. If you have any questions regarding this letter, don't hesitate to contact myself or Fridrich Housa, Deputy Technical Director (fhousa@aasb.gov.au).

Yours sincerely,

Dr Keith Kendall
Chair – AASB

APPENDIX

AASB responses to questions raised in the IASB Request for Information on Post-implementation Review of the classification and measurement requirements of IFRS 9 *Financial Instruments*

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.

The AASB agrees that the IFRS 9 classification and measurement requirements do, in most cases, 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, which results in an entity providing useful information to the users.

However, we encourage the IASB to review several areas where the lack of guidance and the level of judgement involved may unnecessarily add to the cost of financial statements' preparation and may result in diversity of the application of the IFRS 9 requirements. Specific requests for further improvements to IFRS 9 through additional standard setting, application guidance, or illustrative examples are in Questions 2– 9.

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).

The AASB supports the principle-based approach to the classification and measurement of financial assets and agrees that the business model assessment generally works as intended, can be applied consistently in most cases and provides useful information about how the entity manages its financial assets to generate cash flows. However, we request the IASB to consider the need for further standard setting, application guidance or additional illustrative examples in the following specific areas:

(a) Additional guidance regarding the assessment of when sales would be considered 'infrequent' or 'insignificant in value' in the context of a held-to-collect contractual cash flows business model. IFRS 9 paragraph B4.1.2C notes that an entity must consider information (such as the frequency, value and timing) within the context of the reasons for those sales and the conditions that existed at that time. However, additional guidance in this area, for example to illustrate whether the size or frequency of sales is compared to the size of a portfolio (instead of total assets) and whether they should be considered within the reporting period, or the life of the portfolio may improve consistency of application of the requirements and reduce the cost to preparers.

(b) IFRS 9 paragraph B4.1.2 notes that an entity's business model does not depend on management's intentions for an individual financial instrument and that classification should be determined at a higher level of aggregation. The AASB recommends the IASB to consider providing additional guidance or illustrative examples of the circumstances when an entity is permitted to create a new classification for an individual financial instrument if it were (for example) sufficiently material and would represent a new business model for the entity. This is particularly relevant for non-financial services entities.

(c) In 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 in accordance with IFRS 5 *Non-current Assets Held for Sale*

and Discontinued Operations. Accordingly, we request that the IASB confirm whether a reporting entity performs the business model assessment required by IFRS 9 from a group perspective in its consolidated financial statements rather than from the subsidiary's perspective.

(d) Applying the business model assessment first at reporting entity level (or lower) as required by paragraph B4.1.2 and again at group level can introduce operational complexity and counterintuitive results. For example, where for practical purposes, all loans are originated by one group entity and a portion of those loans will be transferred to another group entity (e.g., for capital management purposes), the business model at the originating entity level may be both collecting contractual cash flows and selling financial assets. However, at group level all loans may in fact be held to collect. The AASB recommends the IASB to consider providing additional guidance or illustrative examples on making business model assessments for groups where there are intra group transfers. A related point, stakeholders had different views on the application of paragraph B4.4.3(c) with respect to transfers between business units with different business models when there is no change in the intention for managing the asset on an on-going basis.

(e) Similarly, we request further guidance in respect of transfers of assets (such as receivables) to third parties in an arrangement where the transferor legally transfers the assets but does not achieve derecognition under IFRS 9 because of a continuing involvement (e.g., a credit guarantee). Some stakeholders noted there are different views about whether the transferred assets (that have not achieved derecognition) should be assessed by the transferor as ‘held to collect’ or as ‘held to collect or sale’.

(f) A financial asset can be originated unintentionally, for example, the unsold portion of a syndicated loan. In such cases, the business model may not be known at initial recognition. Accordingly, we request further application guidance about the timing of the determination of the business model on initial recognition as required by IFRS 9, sections 4.1 and B4.1, specifically paragraph B4.1.2A.

Question 3—Contractual cash flow 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).

The AASB agrees that in most cases, requiring entities to classify and measure their financial assets according to the asset's cash flow characteristics provides users of financial statements with useful information about the amount, timing, and uncertainty of future cash flows.

However, whilst applying the cash flow characteristic requirements works well most of the time, there are times when the assessment of whether the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) seems unnecessarily complex, or the degree of judgement required may result in a diversity of application. Several stakeholders, including representatives of preparers and auditors found the level of detail that must be considered in evaluating the terms and conditions of some instruments can be significant and result in

counterintuitive outcomes. We request the IASB to consider the need for further standard setting, application guidance, or illustrative examples in the following areas:

(a) Most stakeholders that responded to our outreach considered that financial assets with contractual cash flows linked to sustainability targets specific to the borrower should represent a basic lending arrangement and accordingly, amortised cost measurement would provide the most useful information to the users. However, such arrangements may often fail the SPPI criterion. Given the increasing prevalence of sustainability-linked features in lending arrangements, we think it is important for the IASB to consider this matter, including additional guidance on when such loans are 'basic lending arrangements' and whether the current application of IFRS 9 consistently results in information that is useful to users of financial statements. Some stakeholders suggested that it would be useful to be able to consider some of these features on a materiality basis for the purposes of the SPPI test beyond the de minimis assessment. However, the AASB would not support arrangements linked to external sustainability targets such as changes in an index or equity price be measured at amortised cost unless the effects are de minimis.

(b) Our stakeholders find the guidance for contractually linked instruments (CLIs) difficult to understand and apply, and we recommend the IASB to consider providing more explicit guidance. For example, confirmation that more than one tranche would constitute 'multiple' tranches even when a tranche does not exist in the form of a note or security (e.g., if a special purpose vehicle (SPV) issues a single note with the excess spread retained by the SPV, whether the latter would constitute a tranche and further, whether the two tranches would be considered as multiple tranches).

(c) We request clarification on applying the SPPI requirements to intercompany loans with non-market interest rates or flexible repayment terms (including prepayment features). To the extent that interest cash flows are ‘off-market’, this will be reflected in determining the initial fair value of the financial instrument. Some stakeholders noted that the interaction between the requirements of paragraphs B5.1.1 and B5.1.2A including references to the prevailing market rates for similar instrument with similar credit rating, and valuation techniques using only data from observable inputs, is not clear. Further, an interest-free or below-market rate loan often contains a prepayment feature that is exercisable at par and any prepayment features need to be analysed for compliance with the SPPI criterion. Stakeholders noted lack of clarity about what constitutes 'reasonable compensation' for early termination or extension of a contract, as this term is not defined.

(d) The interaction between contractual versus non-contractual bail-in powers and non-viability requirements beyond the current example of Instrument E in paragraph B4.1.13 is not clear. For example, there may be inconsistency in application and judgment applied in the assessment of whether the contract merely acknowledges such legislation (as is sometimes required in Australia) and does not create additional rights or obligations and how such a reference impacts the SPPI test.

(e) Concerning non-recourse loans, paragraph B4.1.17 stipulates an asset does not satisfy the SPPI criterion if the terms of the agreement give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest. We request guidance on the practical application of these requirements. For example, if an entity makes a non-recourse loan, the distinction between asset risk and credit risk may be assessed based on the extent of collateral held for the loan, but it is not clear at what point the fair value of collateral held would allow the loan to pass the SPPI test (because the interest rate will be assumed to

mainly reflect ordinary lending risks). Without guidance, different entities may apply this requirement differently.

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).

We agree that the option to present fair value changes on investments in equity instruments in other comprehensive income (FVOCI) provides useful information. However, we consider the lack of a clear underlying principle for the classification category to be a drawback.

Specific types of equity instrument our stakeholders have seen designated into this category include:

(a) high dividend-paying investments where the lack of recycling of gains from other comprehensive income to profit or loss does not significantly impact the information needs of users;

(b) equity investments of some not-for-profit entities where the recognition of gains and losses on these investments in profit or loss would not provide more useful information to users of the financial statements, such as grantors; and

(c) government equity investments (including some investments in private funds and corporations) generally held for policy reasons rather than for trading and investment returns.

Stakeholders had mixed views on the issue of recycling gains and losses from OCI to profit or loss. In some cases, stakeholders identified the lack of an underlying principle or distinction between non-recycling of the fair value gains and dividend income recognised in profit or loss as an issue. Others said

the requirement in paragraph B5.7.1 that a dividend is not recognised in profit lor loss if it clearly represents a recovery of the part of the cost of the investment, without further specifying how ‘cost’ is determined may result in diversity in practice in some cases.

If recycling were to be introduced, stakeholders noted that they would not support the reintroduction of the impairment testing that caused significant application issues under IAS 39 *Financial Instruments: Classification and Measurement*.

The AASB recommends further work on presenting fair value changes on investments in equity instruments in OCI and the issue of OCI and recycling more broadly. While OCI seems relevant to understanding an entity's financial performance, there is a lack understanding of the principles underlying the classification category and further research may be needed.

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.

The AASB did not receive any significant feedback on the issue of financial liabilities and own credit, but some stakeholders noted that measuring fair value changes due to own credit is evolving, and differing approaches in practice to measuring and isolating such changes and inputs into the measurement techniques are possible.

Regarding question 5(b), our feedback on the related topics of derecognition, continuing involvement, modifications, movements in market rates of interest, and other changes in estimates (catch-up adjustments) is in our response to Questions 6, 7 and 9.

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.

The AASB supports further standard setting or additional guidance regarding the definitions and accounting treatment of non-substantial modifications to the contractual cash flows of financial assets and liabilities to clarify the Board's intentions and improve the consistency of application.

Our stakeholders requested more guidance on operationalising the distinction between substantial and non-substantial modifications for financial assets, and to a lesser extent, liabilities. Although IFRS 9 notes a 10% change in the present value of a financial liability is a substantial modification (paragraph B3.3.6), such guidance does not exist for financial assets. Further, there is no qualitative guidance for either assets or liabilities. This has led entities to develop their own accounting policies for what constitutes a significant modification which may have resulted in the diversity in practice.

Our stakeholders noted that in practice, modifications are generally limited to changes in contractual terms resulting from a bi-lateral agreement of the parties to the contract and not (for example) to changes to the underlying calculation of indexes used as the basis of the contractual terms, as was highlighted in the Board's deliberations on accounting for the effects of interest rate benchmark reform. If such changes were required to be accounted for under paragraph B5.4.6, leading to an immediate impact in profit or loss, it could represent a change in practice as many entities may take the view that such changes in a calculation of the index are changes to a market rate in scope of paragraph B5.4.5.

Paragraph 5.4.3 requires recalculation of the gross carrying amount of the financial asset, discounted at the original effective interest rate, and recognition of a modification gain or loss immediately in profit or loss. The requirement to discount at the original effective rate can lead to counterintuitive results, for example when a 'blend and extend' arrangement on commercial terms is considered a non-substantial modification. That is, when a fixed rate loan is extended prior to maturity with the extension period priced at market rate, but the contractual interest rate is amended so that an economically neutral 'blended' rate applies from the date of the modification to the new extended maturity, paragraph 5.4.3 requires the modified cash flows to be discounted at the original effective interest rate. This results in the recognition of a modification gain or loss which would unwind over the new extended term. Some stakeholders noted that the gain or loss recognised upon modification is

unlikely to provide useful information to financial statements users as the lender has renegotiated the terms at market rate.

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).

Based on the outreach performed, in straightforward cases, amortised cost and the effective interest rate method is easy to apply and provides users with useful information. However, when there is a change in contractual cash flows, the decision to apply paragraph B5.4.5 (the prospective adjustment) versus paragraph B5.4.6 (the catch-up adjustment) is not always straightforward, including identifying whether a change is a change in market rates. Some stakeholders noted that the lack of guidance and a lack of clear principle as to why some adjustments to contractual cash flows are accounted for prospectively whilst others are accounted for with a cumulative catch-up in current year profit or loss likely results in diversity in practice with entities determining their own accounting policies in this area.

Our responses to Questions 6 and 9 describe related issues to the above.

The AASB supports the IASB to consider further standard setting or additional guidance regarding the treatment of modifications, movements in market rates of interest, and other changes in estimates (catch-up adjustments) of the contractual cash-flows for financial assets and financial liabilities.

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?

For many entities, the application of transition requirements was straightforward; however, implementing the requirements required considerable effort for others. This was mainly due to the phased approach taken with IFRS 9 and the interaction with other accounting standards.

The AASB recommends the IASB to consider field testing when the transition requirements for a new standard are expected to be complex and to avoid a phased approach to standard setting in future where possible.

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?**

The matter our stakeholders raised most frequently that was not included in this post-implementation review was the difficulty of applying the recognition and derecognition requirements of IFRS 9, particularly for 'pass-through' and continuing involvement transactions. In this regard, reference was also made to the increase in risk-sharing transactions and complex factoring and reverse factoring arrangements that adds to the need for further application guidance.

The AASB notes that in May 2016, the Interpretations Committee considered and declined to undertake a narrow-scope project to clarify when a modification or exchange of financial assets results in derecognition of the original asset because of the broad nature of the issue.

The AASB recommends the IASB to consider further standard-setting work or guidance on this area.