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Dear Sir or Madam

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

We are pleased to comment on the above Request for Information (the RFI). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the RFI.

Our responses to the questions in the RFI are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)7875 311782 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

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Appendix

Classification and measurement

Question 1(a) – Do the classification and measurement requirements in IFRS 9 enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

In our experience, applying the classification and measurement requirements of IFRS 9 generally aligns the measurement of financial assets with the cash flow characteristics of the assets and how those assets are managed. See further response below to Spotlight 3.1.

Question 1(b) - Do the classification and measurement requirements in IFRS 9 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?

In our experience, the classification and measurement requirements in IFRS 9 generally result in useful information provided to the users of the financial statements. However, we are seeing an increasing number of ESG-linked features in financial instruments, with the effects of those features growing in significance. We encourage the IASB to provide guidance and requirements for the analysis of these types of instruments for both financial assets (such as green bond investments) and financial liabilities (including the potential separation of embedded derivatives) in accordance with the requirements of IFRS 9.

Business model for managing financial assets

Spotlight 2 - The Board would like to understand in which situations and how frequently reclassifications have occurred. Furthermore, the Board is interested in information about situations in which a significant event has occurred but for which the conditions in IFRS 9 for a change in business model have not been met.

Generally, we have not observed reclassifications occurring nor have we observed situations in which a significant event has occurred and the change in business model conditions have not been met.

Question 2(a) – Is the business model assessment working as the Board intended? Why or why not?

Yes, in our experience, the business model assessment is working as the Board intended.

Question 2(b) – Can the business model assessment be applied consistently? Why or why not?

Yes, we have observed that the business model assessment is being applied consistently. However, in some instances we have observed difficulty in practice with the interpretation of ‘infrequent’ or ‘insignificant’ to determine whether sales that occur for other reasons are consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows.

Question 2(c) – Are there any unexpected effects arising from the business model assessment? How significant are these effects?

In our experience, generally there are not unexpected effects arising from the business model assessment. However, we have noticed instances in practice where there are different views regarding the interpretation of ‘selling financial assets’. Some preparers question whether to be considered a sale of a financial asset a legal sale is sufficient or whether, in addition, the derecognition requirements in IFRS 9 for financial assets are required to be met.

<u>Contractual cash flow characteristics</u>

Spotlight 3.1

<u>Financial instruments with sustainability-linked features</u>

3.1.1 - The Board is seeking information about whether:

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

IFRS 9 does provide sufficient guidance to determine whether financial assets with sustainability linked features have SPPI cash flows (following the requirements of IFRS 9, unless the variation in cash flows arising from the sustainability-linked feature are de minimis, then technically the instruments would typically fail the SPPI test). However, we do not believe that the resulting measurement of these financial assets (fair value with changes in fair value being recorded in profit or loss) provides useful information to users of financial statements because many of the financial instruments could be regarded as giving rise to a basic lending arrangement.

We believe that the Board needs to consider whether and how a financial instrument’s sustainability-linked features can result in a financial asset having SPPI cash flows, as those features often also have an ESG objective such as lower rates/payments if certain carbon emissions are achieved.

Financial assets with contractual cash flows linked to ESG targets

3.1.2 - In their assessment, some stakeholders considered whether in some circumstances interest rate adjustments linked to ESG targets could be SPPI because they represent consideration for the credit risk of the financial assets. The Board would like to understand the contractual terms of financial assets for which stakeholders think this could be the case, and how the entity makes this assessment and considers the relationship between the ESG targets and the credit risk associated with the principal amount outstanding as described in paragraph 4.1.3(b) of IFRS 9.

3.1.3 - In their assessment, some stakeholders considered whether in some circumstances interest rate adjustments linked to ESG targets could be SPPI because they represent a profit margin. The Board would like to understand the contractual terms of financial assets for which stakeholders think this could be the case and how the entity makes its assessment and considers paragraph B4.1.10 of IFRS 9, which applies to contractual terms that could give rise to variability in the contractual cash flows.

3.1.4 - Some other stakeholders take an approach that asks 'for what risk or exposure does the ESG-linked variability in the contractual cash flows compensate the entity?' The Board would like to understand from those stakeholders:

- *which requirements in IFRS 9 are being applied to support this approach;*
- *what contractual terms and conditions of the financial asset are being considered applying those requirements; and*
- *what conclusions they are reaching and why.*

Response to questions 3.1.2 – 3.1.4:

In practice, the financial effects of ESG-linked features have typically been small and could be regarded as being de minimis. However, we have started to see ESG-linked features which have a greater potential effect, and therefore, might be regarded as more than de minimis. We recommend that the Board considers developing further guidance on how ESG features affect the accounting for a financial instrument and the determination of de minimis.

Financial liabilities with sustainability-linked features

3.1.5 - Some stakeholders noted that the issuer of sustainability-linked bonds will need to assess for the financial liability whether the sustainability-linked features are embedded derivatives and if so, whether they need to be separated from the host contract. The Board is aware that stakeholders have been discussing this assessment, but is not aware of any concerns or questions in this regard.

We agree that financial instruments with sustainability-linked features will need to be assessed to determine whether these features give rise to embedded derivatives. However, we believe that these features could be regarded as not giving rise to an embedded derivative because there may be a non-financial variable which is specific to a party to the contract. If that were to be the case, then the financial liability would be accounted for in accordance with IFRS 9.B5.4.6 and an embedded derivative would not be separated. However, we are aware that there is some diversity in how the boundary for non-financial variables that are specific to a party to the contract is interpreted and applied in practice. If a narrow view is taken, sustainability linked features would be likely to give rise to embedded derivative(s).

Spotlight 3.2 – Contractually linked instruments

The Board would like to understand the fact patterns to which the requirements for contractually linked instruments are being applied, and the outcome of applying them.

The Board also would like to understand whether IFRS 9 provides sufficient application guidance on contractually linked instruments, for example, on the scope of the financial assets to which the requirements apply.

The Board would like to understand in what circumstances it is complex to assess whether a financial asset is a contractually linked instrument and why it is complex.

We have no specific observations.

Question 3(a) - Is the cash flow characteristics assessment working as the Board intended? Why or why not?

In our experience, generally, the cash flow characteristics assessment is working as the Board intended. However, as noted in our comments above additional clarification is needed with regards to the application of SPPI to financial instruments with sustainability-linked features.

Question 3(a)(i) - 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 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).

See our comments above relating to the application of the SPPI requirements to financial instruments with sustainability-linked features.

Question 3(a)(ii) - 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) 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.)*

We have no specific observations related to this question.

Question 3(b) - Can the cash flow characteristics assessment be applied consistently? Why or why not?

We have observed that there is diversity in practice for the analysis of financial instruments with sustainability-linked features.

Question 3(c) - Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

No, we have not observed unexpected effects arising from the cash flow characteristics assessment.

<u>Equity instruments and other comprehensive income</u>

Spotlight 4 – Recycling gains and losses

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

We believe that OCI for equity instruments should not be reclassified into profit or loss in a future period. If recycling were to be required on the disposal of an equity instrument classified as Fair Value though OCI, entities would be able to manipulate reported results by disposing (or not disposing) of investments in equity instruments, and by selecting particular instruments either to retain or sell. Further, we believe that recycling would reintroduce the practical issues previously caused by the accounting for the impairment of available-for-sale financial assets in accordance with the requirements of IAS 39 and result in diversity in practice.

Question 4(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?

Yes, the option to present fair value changes on investments in equity instruments in OCI is working as the Board intended.

Question 4(b) - For what equity instruments do entities elect to present fair value changes in OCI?

Some of the instances where we have observed that entities elect to present fair value changes in OCI are as follows:

- the investments are not part of the entities normal trading operations, so the entity chooses to not recognise the fair value movement on these instruments in profit or loss;
- certain unquoted equity instruments that are held for medium- or long-term strategic consideration; and
- to avoid differences with local GAAP or where the intention and practice is to hold the investment for the long term.

Question 4(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?

No, we are not aware of any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI.

However, on a related point (because an investment in equity instruments which is classified as held for trading cannot be measured at FVOCI) we have noted that some preparers of financial statements would like further clarification for the meaning of ‘held for trading’, such as was previously included in IAS 39.AG14.

<u>Financial liabilities and own credit risk</u>

Question 5(a) - Are the requirements for presenting the effects of own credit in OCI working as the Board intended? Why or why not?

Yes, generally, the requirements for presenting the effects of own credit in OCI are working as the Board intended. However, we have observed entities encountering difficulty when the fair value option is used in developing a model to identify own credit risk separate from the other aspects of changes in fair value.

Question 5(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)?

Yes, we suggest the Board consider including additional illustrative examples for financial liabilities. For example, the initial recognition (day one) and subsequent (day two) accounting for debt with warrants.

<u>Modification to contractual cash flows</u>

Question 6(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?

Yes, generally, we have observed that the requirements for modifications to contractual cash flows are working as the Board intended. However, we believe there should be further consideration by the Board of modifications of financial liabilities focussed on when there are multiple changes such as pre-payments, changes to the principal amount outstanding, and interest rate or other changes.

We suggest the Board consider including additional illustrative examples for modifications of debt in the following areas:

- Determining whether to derecognise debt when there is a modification of the contractual terms to change from a fixed to a variable rate combined with additional borrowings and/or repayments and prepayments.
- Performing the ‘10 per cent’ test for derecognition of financial liabilities when there is a modification for additional borrowings.

Question 6(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.

Generally, yes, the requirements for modifications to contractual cash flows can be applied consistently. However, we have observed some diversity in practice related to the application of IFRS 9.B3.3.6 and the allocation of costs or fees.

We have also observed that the guidance related to financial assets is not as clear as the guidance for financial liabilities. We suggest the Board provides additional guidance and clarification in circumstances where the terms of financial assets are renegotiated.

<u>Amortised cost and the effective interest method</u>

Question 7(a) - Is the effective interest method working as the Board intended? Why or why not?

Yes, we believe the effective interest method is working as the Board intended although there can be complexities in its application.

However, the recent discussions at the IFRS Interpretations Committee about TLTRO III arrangements have highlighted a number of issues that we believe the Board needs to address. These include the appropriate unit of account for the purposes of the application of IFRS 9.B5.4.5 or B5.4.6 (should an interest rate be split into components and, if so, in what circumstances), and clarification of what represents a market rate of interest for the purposes of B5.4.5.

Question 7(b) - Can the effective interest method be applied consistently? Why or why not?

Yes, we believe the effective interest method can be applied consistently. However, as noted in our response to question 7(a) there can be complexities in its practical application and there are certain issues arising from recent discussions at the IFRS Interpretations Committee that need to be addressed. We have also observed that ESG-linked contracts can include variable payment terms for both principal and interest.

We believe that it would be appropriate for the Board to include additional guidance to address these scenarios. We suggest the Board also consider including an additional illustrative example of the application of the effective interest rate method.

<u>Transition</u>

Question 8(a) - Did the transition requirements work as the Board intended? Why or why not?

Yes, the transition requirements worked as the Board intended. We have not encountered difficulties in practice.

Question 8(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?

Generally, no, there were not any unexpected effects of, or challenges with, applying the transition requirements.

Other matters

Question 9(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?

We suggest the Board consider providing further clarification related to the accounting for electronic transfers.

As well as the question of the effective interest rate and amortised cost accounting (in particular the application of IFRS 9.B5.4.5 and B5.4.6) arising from the discussions by the Interpretations Committee about TLTRO III arrangements (see our response to question 7(a) above), we believe that the discussions have also highlighted the need for a review of the interaction between IFRS 9 and IAS 20. This should include consideration of the accounting both at initial recognition and subsequently when there is conditionality around a government grant.

In addition, we suggest that a review is carried out of IFRS 9 related IFRS Interpretations Committee (Committee) agenda decisions. This review would be to identify those agenda decisions where the Committee did not add an issue to its agenda because it might be addressed by an existing Board project, but the project was not ultimately completed or did not address the issue that had been raised with the Committee. Consideration should then be given to whether and how the issues identified might now be dealt with (for example, through narrow scope amendments to IFRS 9).

Question 9(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?

We have no specific observations related to this question.