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27 January 2022
602/636

Re.: IASB Request for Information: Post-implementation Review, IFRS 9 *Financial Instruments* – Classification and Measurement

Dear Mr Barckow

The IDW appreciates the opportunity to comment on the IASB's Post-implementation Review (PIR): IFRS 9 *Financial Instruments* – Classification and Measurement.

We believe that the classification and measurement requirements in IFRS 9 are generally working as intended. However, there are some topics that in practice are difficult to apply and/or where there is a lack of guidance, running the risk of inconsistent application and not delivering relevant information to users.

In particular, the increase in environmental, social and governance (ESG)-linked financial instruments, both in terms of their types and values, pose a challenge to the criterion of 'solely payments of principal and interest' in IFRS 9. This is not surprising given that when IFRS 9 was developed such instruments were not prevalent. However, it is expected that such instruments will be pervasive, e.g., in the EU as part of the Green Deal. Hence, we urge the IASB to consider this issue as soon as feasible and develop guidance on the appropriate accounting for such instruments. We recommend treating this as a separate high-priority project and not discussing this issue as part of the PIR of IFRS 9.

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Daniela Kelm, RA LL.M.;
Melanie Sack, WP StB

In the context of the above, but also as part of many previous and current technical discussions – most recently the IFRS Interpretations Committee's discussion on the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTRO) III – , we note that the guidance in IFRS 9.B5.4.5 and IFRS 9.B5.4.6, while carried forward from IAS 39, increasingly gives rise to significant challenges in practice. This issue will become particularly relevant for ESG-linked instruments measured at amortised cost, but also in relation to other more traditional financial instruments that foresee variability in cash flows driven by the occurrence of defined events.

In addition, we think that the guidance on reclassifications and permissible sales could benefit from more clarity and question whether the high thresholds for reclassifications still serve the purpose of reflecting how financial assets are managed.

Furthermore, the issue of modifications of financial assets remains unresolved. This is unsatisfactory from a conceptual perspective, as there is a void in the standard on an issue of high practical relevance. We do not advocate resolving this issue as part of the PIR on classification and measurement in isolation. In particular, there are cross-cutting issues with the requirements relating to expected credit loss (ECL), so that we encourage the IASB use the forthcoming PIR on ECL to gather information and then reflect the comprehensive feedback received in a thorough resolution of the issue of modifications.

We note that the issue of recycling of equity instruments measured at fair value through other comprehensive income (OCI) will become highly relevant in the insurance sector. However, we would also highlight that this issue is less pervasive in other industries that already apply the requirements of IFRS 9. If the IASB decides to allow or require recycling of gains or losses recognised in OCI, we believe it will require a robust impairment model in order to avoid the issues evidenced when IAS 39 had the 'significant or prolonged decline' impairment model.

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 IDW notes that, overall, the classification and measurement requirements in IFRS 9 have worked well. In general, the implementation of the requirements has not led to significant changes in the subsequent measurement attributes of financial instruments. In certain situations, however, changes were sizeable.

We believe the classification and measurement model, in general, leads to useful information which is auditable. However, some of the guidance in IFRS 9 and its interaction did prove challenging as noted below.

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' 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).

In our view, the business model assessment in IFRS 9 is working as intended. Having said this, there are situations where the requirement to assess the business model at initial recognition can lead to a subsequent measurement that does not reflect how the financial instruments are actually managed subsequently. One example is that of failed syndications, where an entity (typically a financial institution) enters into a syndication transaction with the aim of syndicating a fixed percentage to external parties but fails to achieve that percentage. As a result, it either continues its efforts to syndicate the outstanding proportion or, ultimately, decides to keep it and transfer that proportion to the banking book. In such cases, IFRS 9 specifies that the business model can neither be classified as 'hold to collect' nor 'hold to collect and sell' and, therefore, the failed part of the syndication must be measured at fair value through profit or loss, although, in many cases, the entity's intention is now to hold these instruments in order to collect contractual cash flows.

Regarding reclassifications, we would like to highlight that in practice the thresholds set by IFRS 9 generally lead to very limited reclassifications/changes in business models. Even under the current Covid-19 pandemic situation reclassifications were, and remain, rare. We understand that it was the Board's intention to limit reclassifications to avoid, i.a., earnings management. Certainly, this view was influenced by the financial crisis at the time IFRS 9 was developed. The downside of this strict reclassification model is that there can be circumstances where financial assets are carried at measurement attributes that do not reflect the business model they are held within which, in turn, reduces the relevance to users.

In addition, the guidance on when sales do not contradict a business model 'hold-to-collect' is challenging and not free of ambiguity. This concerns e.g., the question of how to operationalise the terms 'infrequent' and 'insignificant'. Several application questions arise in this context, e.g., whether only sales within the current reporting period are to be considered in the assessment or whether sales from previous reporting periods must also be taken into account. We would ask the Board to use the feedback and outreach during the PIR of IFRS 9 to gather further evidence as to whether these requirements are applied consistently by all entities preparing financial statements in accordance

with IFRS. An adjustment to paragraphs IFRS 9.B4.1.3A/B and/or further guidance on these paragraphs could potentially provide more clarity for application in practice.

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).

In the IDW's view, the guidance on contractual cash flow characteristics is helpful in determining the appropriate measurement attribute for financial assets in conjunction with the business model assessment.

Having said this, we would like to point out the challenges arising from financial instruments where cash flows are linked to sustainability features. While these instruments are currently relatively small both in terms of volume compared to traditional lending and in magnitude of the features, given the strong dynamics in the field of sustainability and the political momentum in many jurisdictions including the EU, this is expected to change soon. While the assessment of the cash flow characteristics is principles based, payments that vary with sustainability features do not fit well within the guidance on this assessment.[1] The existing routes to build such features into the current guidance, such as 'de minimis' or linkage to credit risk, will not provide a robust basis in the future. We believe that such features will become part of basic lending arrangements in the sense of customary market practice and, hence, c.p. should, as traditional basic lending arrangements, qualify for amortised cost measurement provided an amortised cost measurement using the effective interest rate results in relevant information (see also our response to question 7) if the corresponding business model criterion is met.

We urge the Board to consider this matter as a high priority. Given the anticipated timeline for the PIR of IFRS 9, we believe that the urgency of this matter justifies separating this issue from the other parts of the PIR. Constituents

[1] In this context we refer to the IDW Knowledge Paper: Accounting for 'green' financing, 01.07.2021, available at: https://www.idw.de/blob/132350/f206d2d4d7d745ce9dc6396be30405cf/down-bilanzierunggruenerfinanzen-englisch-data.pdf.

would greatly benefit from standard-setting on a timely basis regarding this particular issue.

We ask the Board to use the feedback received from the PIR of IFRS 9, including any from outreach activities, to gather further evidence as to whether the requirements are applied consistently by all entities preparing financial statements in accordance with IFRS. We would like to point some examples, which might cause inconsistencies in practice:

- inclusion of the criteria 'de minimis' and 'non-genuine' in the assessment of whether a contractual cash flow characteristic does/does not affect the classification of a financial asset (we refer to IFRS 9.B4.1.18)
- assessment of when an application of the guidance on contractually linked instruments is required and when the application of the guidance on non-recourse financial assets is appropriate (we refer to IFRS 9.B4.1.20 et seqq. and IFRS 9.B4.1.15 et seqq.).

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 note that, outside the insurance sector, the guidance has worked well in practice for most entities in most industries where IFRS 9 is applicable. However, after the transition to IFRS 9, the insurance sector will be affected significantly, which is not only due to the current OCI presentation option for equity instruments without recycling in IFRS 9, but also due to the new measurement model for insurance contracts. We ask the Board to take a fresh look at this issue and consider whether the issue, given that it primarily affects insurers due to the interaction with the requirements of IFRS 17, could be addressed in IFRS 17 rather than IFRS 9, since the latter applies to all entities. This would have the benefit of not changing current practice for entities that already apply IFRS 9 without any related application issues.

Should the Board decide to reintroduce the recycling of gains and losses on the disposal for equity instruments for which the OCI presentation option was applied, we would like to point out that any such requirement must be accompanied by a robust impairment model.

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 IDW believes that the requirements have achieved the Board's objective and result in relevant information. One challenge and potential source of diversity in practice is how the portion of fair value changes relating to own credit risk is determined. In our view, this is not a widespread issue at present, but it could become more relevant in the future, if markets conditions change.

For example, it is expected that the contractual terms and conditions in loan agreements will increasingly include sustainability aspects that will also be relevant in determining the company's own credit risk.

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.

Modifications to contractual cash flows are a long-standing issue of IFRS 9 and its predecessor standard IAS 39. Although some modifications are generally expected to be derecognition events for financial assets, to date there is no specific guidance for financial asset modifications. In practice this gap has been filled using analogies to the liability side of the balance sheet and other guidance (e.g., the IFRS IC's agenda decision on Greek Government Bonds), but it is not conceptually sound to have this gap in the requirements. The ac-

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counting approaches developed against this background are not applied consistently and given the lack of principles in the standard, it is difficult to enforce or reject a particular approach.

An additional challenge is the interaction of the requirements for modifications to contractual cash flows with other guidance in IFRS 9; notably the requirements for impairment. Some constituents perceive it to be unclear whether either the requirements for modifications to contractual cash flows or the requirements for derecognition must be applied before applying any impairment guidance (or vice versa), while others interpret the current guidance to be clear in this regard. These different viewpoints have led to diversity in practice.

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).

While the effective interest method is well understood in theoretical and mathematical terms, the treatment of changes in expected cash flows including contingent cash flows leads to application questions and divergent views. In particular, it is not clear what constitutes a change in a market rate and how the guidance in IFRS 9.B5.4.5 and IFRS 9.B5.4.6 applies to specific changes such

as credit or other margin elements. This has led to various requests to the IFRS IC and additional guidance in supporting technical literature. The IFRS IC has recently discussed this issue again in the context of the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTRO) III. The corresponding staff paper for the IFRS IC's November meeting, presented a view, which, however, does not necessarily coincide with practice. The issue will be even more relevant for financial instruments with sustainability features.

As this is a long-standing issue that is increasingly prevailing under current market practices, we think the Board should address this issue comprehensively and clarify and/or amend its guidance on reflecting changes in expected cash flows as part of applying the effective interest method to make it future-proof and robust to reflect new cash flow features that were not prevailing when the predecessor guidance in IAS 39 was developed and carried forward to IFRS 9.

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?

In general, the transition to IFRS 9 has worked well and the guidance has been sufficiently clear. However, significant efforts in transition have been made by preparers, auditors and other stakeholders; often with limited impact on the actual subsequent measurement attributes of the financial instruments concerned.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

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