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PIR of IFRS 9—Classification and Measurement – Modifications and amortised cost measurement and effective interest method Issues Paper

Objective

1 To inform EFRAG FR TEG about the PIR findings in respect of modifications of financial assets and financial liabilities and amortised cost measurement and the effective interest method and recent IASB decisions in respect of these two topics.

Structure of this paper

2 This paper is structured as follows:

(a) Background of the project;

(b) Modifications of financial assets and financial liabilities – analysis of the feedback received;

(c) Amortised cost measurement and the effective interest method - analysis of the feedback received;

(d) The analysis and prioritisation assessment of PIR findings; and

(e) The IASB decision.

Background of the project

3 In October 2022, the IASB decided to start the PIR of the IFRS 9 - *Classification and Measurement*. The Request for Information was published on 30 September 2021 with comments to be provided by 14 January 2022.

4 EFRAG provided a response to the RFI in January 2022.

5 During March – July 2022 the IASB discussed various aspects of the feedback received. Based on its analysis, the IASB decided in May 2022 to start a standard-setting project to clarify particular aspects of the requirements in IFRS 9 *Financial Instruments* for assessing the contractual cash flow characteristics of a financial asset.

6 At its July 2022 meeting the IASB discussed feedback received on the requirements in IFRS 9 *Financial Instruments* for:

(a) modifications of financial assets and liabilities (Agenda Paper 3A); and

(b) amortised cost measurement and the effective interest method (Agenda Paper 3B).

7 Based on its analysis and prioritisation assessment (Agenda Paper 3C), the IASB decided to add a standard-setting project to its research pipeline to clarify the

requirements in IFRS 9 for modifications of financial assets and liabilities and applying the effective interest method.

Modifications of financial assets and financial liabilities – analysis of the feedback received

8 Most respondents, including most of the accounting firms, said that modifications of financial assets are one of the areas for which most questions arise in practice and that IFRS 9 could benefit from clarification and additional application guidance.

9 Respondents noted the diversity in practice with regards to the financial assets and attributed it to the fact that there is no underlying principle to determine when a modification results in derecognition. Many respondents said that the requirements for financial assets in paragraph 5.4.3 of IFRS 9 are less specific than the comparable requirements for financial liabilities.

10 It was also acknowledged that the modification requirements were not new and were carried forward from IAS 39 practically unchanged and questions about the application of these requirements have been asked long before IFRS 9 was finalised.

11 The following application challenges were mentioned by respondents:

(a) **Absence of the definition for a modification**: it is unclear whether it refers to changes in contractual terms of the financial instruments or changes in contractual cash flows;

(b) **When a modification results in derecognition**: insufficient guidance on how to determine if a modification leads to derecognition, including how to assess whether a modification is 'substantial' and when to use qualitative or quantitative indicators or both;

(c) **Difference between partial derecognition and a modification**: it is unclear if the assessment of whether the modification leads to derecognition is based on:

(i) the notion of the expiry (or cancellation) to the right of the contractual cash flows and therefore be accounted for as a partial derecognition; or

(ii) a modification of contractual terms applying paragraph 5.4.3 or paragraph B5.4.6 of IFRS 9 and the recognition of an associated gain or loss in profit or loss.

(d) **Calculation and recognition of a modification gain or loss**: in respect of credit-impaired financial assets (as a part of ECL or as a modification gain/loss) and the treatment of fees incurred.

12 The IASB Staff considers that issuing educational material or adding illustrative examples could supplement but not replace the need to clarify the scope and the application of the requirements. Therefore, in the IASB Staff view standard-setting, rather than other actions from the IASB or IFRS IC, are required to eliminate the diversity in practice and to support consistent application of the requirements.

13 The IASB Staff proposes to consider the following areas for clarification:

(a) what constitutes a modification including the interaction of (or the boundary between) modification and expiry to the rights of cash flows;

(b) the sequence or hierarchy of modifications and expiry to the rights of cash flows; and

(c) treatment of fees and costs as a result of modifying the original contract.

14 The IASB Staff also highlighted the importance to consider the interdependencies with other areas of IFRS 9, most notably the impact on the application of the effective interest method and on the ECL requirements.

Questions for EFRAG FR TEG

15 Does EFRAG FR TEG has any comments on the analysis of the feedback received in respect of modifications?

16 Does EFRAG FR TEG has any comments on the IASB Staff proposals for the standard setting?

Amortised cost measurement and the effective interest method - analysis of the feedback received

17 Most respondents agreed that amortised cost together with disclosures provides useful information to users about the amount, timing and uncertainty of future cash flows. Similar to the responses on modifications of financial assets and financial liabilities (see above), they acknowledged that the requirements for the effective interest method were carried forward from IAS 39 unchanged.

18 Most respondents said that the effective interest method is an area that gives rise to many questions in practice and for which the IASB could make clarifications and provide additional application guidance.

19 Respondents identified two key applications challenges:

(a) **how to reflect in the effective interest rate conditions** attached to the contractual interest rate:

(i) whether estimated future cash payments or receipts should factor in conditional contractual terms; and

(ii) if so, how such conditional terms should be considered in estimating cash flows through the expected life of the financial instrument (by using a probability-weighted average (or expected value), the most likely or best estimate outcome or the statistical median).

(b) how to account for **subsequent changes in estimates of future cash flows**:

(i) either by adjusting the EIR (paragraph B5.4.5 of IFRS 9), but clarifications were needed for the meaning of:

- a **'floating rate'** financial instrument and whether this refers to the overall contractual rate or only a component or element thereof; and
- **'movements in the market rates of interest'** and whether this includes any contractually specified adjustments to the contractual interest rate.

(ii) or through a cumulative catch-up adjustment (applying paragraph B5.4.6 of IFRS 9).

20 Other application questions included:

(a) whether, and when, the EIR of a financial instrument is adjusted following a modification;

(b) how to account for any unamortised transaction costs or any fees received as part of a modification of financial instruments; and

(c) what the meaning of the phrase "fees and costs incurred" is in paragraph 5.4.3 of IFRS 9, in particular whether this includes fees received, fees paid and costs paid by both lender and the borrower.

21 As for the modifications, the IASB Staff notes the long history of questions and concerns about how to interpret and apply requirements of amortised cost measurement and the application of the effective interest method, in particular for floating rate instruments. Therefore, it considers that issuing educational material or adding illustrative examples will not be sufficient and suggests to undertake the standard setting in the following areas, by providing clarification of:

(a) the term 'market rates of interest' in paragraph B5.4.5 of IFRS 9 and what interest rates or market-based variables of the contractual interest rates it relates to;

(b) the term 'floating rate' in paragraph B5.4.5 of IFRS 9 and the interaction with the term 'market rates of interest';

(c) the treatment of conditionality attached to the contractual interest rate and how this conditionality affects the cash flow estimate for the purposes of calculating the effective interest rate; and

(d) the effect modifications have on determining the EIR.

22 The IASB Staff suggests to consider potential interdependencies with other areas of IFRS 9, most notably the requirements for modifications of financial assets and financial liabilities and expected credit losses.

Questions for EFRAG FR TEG

23 Does EFRAG FR TEG has any comments on the analysis of the feedback received in respect of amortised cost measurement and the effective interest method?

24 Does EFRAG FR TEG has any comments on the IASB Staff proposals for the standard setting?

The analysis and prioritisation assessment of PIR findings

25 The IASB Staff applied the new two-step approach to decide whether to take action and how to prioritise it in respect of the PIR findings.

26 Since the topics of modification of financial assets and financial liabilities and the application of the effective interest method are interlinked and both relate to amortised cost measurement, the IASB Staff grouped them together for the purpose of assessing the priority of the findings of the PIR. More details of this analysis can be found in Agenda Paper 3C.

Step 1 - do the PIR findings evidence that further action should be taken?

27 The IASB Staff concluded that:

(a) **the objective of IFRS 9 is not being met** for both modifications and EIR requirements as most respondents stated that further clarification and application guidance may be needed for modifications of financial assets and liabilities and in specific cases of revisions to cash flows estimates for the purpose of the EIR calculation.

(b) **the benefits to the users of financial statements are lower than expected** – given the concerns about diversity in practice in assessing modifications of financial assets and financial liabilities and applying the effective interest method for a floating rate financial instruments, in particular, if there is conditionality attached to the contractual interest rate.

(c) **the costs applying the new requirements are greater than expected** - insufficient application guidance has resulted in significant application, audit and enforcement challenges which is evidenced by the responses to the IFRS IC Agenda Decisions.

28 In the IASB Staff view, most of the characteristics described in step 1 are present in the findings. Therefore, the IASB staff recommend that the IASB considers taking further actions for the findings identified.

Step 2 - is the finding high, medium or low priority?

29 The IASB Staff assessment was **'Yes'** to the four questions listed below:

(a) **the finding has substantial consequences?** - uncertainty about how to apply the requirements for modification and revisions of contractual cash flows already result in diversity in practice. This divergence would not provide useful information to users of financial statements.

(b) **the finding is pervasive?** - considering that the requirements of both topics were carried forward from IAS 39 and the long history of application questions to IFRS IC and the IASB there is clear evidence that the findings concerning both topics are pervasive.

(c) **the finding can be addressed by the IASB or the IFRS IC? –** the findings could be addressed by the IASB through the standard-setting (clarifications and application guidance), rather than interpretation or educational material.

(d) **the benefits of any action would be expected to outweigh the costs?** - any action would focus only on clarifying the requirements and providing additional application guidance, while at the same time being principle-based and generally applicable.

30 Based on the above analysis, the IASB staff recommend to categorise findings as **medium priority**.

31 Being cautious about any potential disruption to the existing practices, the IASB Staff believe that clarifying the requirements would:

(a) maximise the benefits of going through the standard-setting process with relatively small incremental effort; and

(b) minimise the risk of any unintended consequences or impacts that could result from making one amendment in advance of another amendment in the same area of the requirements (i.e., consider the modifications requirements together with the requirements on the effective interest method).

The IASB decision

32 Based on the IASB Staff analysis and prioritisation assessment, the IASB decided to add a standard-setting project to its research pipeline to clarify the requirements in IFRS 9 for modifications of financial assets and liabilities and applying the effective interest method.

33 Any forthcoming standard-setting project will also consider the findings of the PIR of IFRS 9 - *Impairment*.

34 All ten IASB members agreed with this decision.

EFRAG working groups discussions

35 EFRAG FIWG discussed the IASB decisions on 27 September 2022.

36 EFRAG FIWG members generally agreed with direction of the IASB project and prioritisation of the list of issues which they considered comprehensive and well articulated. Members stressed the importance of the interconnectivity of the issues on the EIR, modifications, ECL calculation and also contractual cash flows characteristics and suggested to carefully develop possible solutions to avoid unintended consequences.

37 Members expressed mixed views on the possibility to develop clarifications suitable for all given that the practice has been established and that any changes can be costly to implement and that they might have wider impact outside the accounting numbers, for example on the valuation models used. Some members were concerned that the clarifications might bring changes to the existing practices while others considered that reducing the existing diversity in practice and making financial reporting more comparable was very important.

38 Members suggested that interaction with ECL calculation was particularly important and suggested to add the recent IFRS IC tentative agenda decision ('TAD') on *Lessor Forgiveness of Lease Payments* to the list of issues identified by the IASB Staff. In their view, this TAD raised a question of what type of modifications should be included in the ECL measurement.

39 On EIR estimation, members warned against a sophisticated solution with multiple scenarios and probability calculations. Such an approach could raise question if a resulting valuation can still be considered as amortised cost or rather be closer to fair value, a hybrid method close to indexation. Members reminded that amortised cost was always a simple measurement approach and it should remain simple.

40 Members also noted that the IASB suggestion to consider all the contingent events without probability (especially if the events are mutually exclusive) for the purposes of SPPI test could complicate the estimation of the EIR.

Questions for EFRAG FR TEG

41 Does EFRAG FR TEG has any comments on the IASB Staff analysis and prioritisation assessment?

42 Does EFRAG FR TEG has any comments on the IASB decision to add a standard-setting project to its research pipeline?