Post-implementation Review- IFRS 9 Financial Instruments- Classification and Measurement

Comments

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?**

Comment Yes, the approach provided by IFRS considering business model test and cash flow characteristics test seems fine. The contractual cash flow test considers whether the asset solely provides payments for interest and principal and the business model test provides how an entity manages its financial assets so as to generate or realize cash flows. So, both the assessment of the instrument and management expectation is covered in approach. So, it enables the entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them.

(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?**

Comment Yes, the users are able to estimate the amount, timing and uncertainty of future cash flows. In case of amortized cost where the business model is to hold the financial asset till maturity, the financial asset is recorded at present value which helps to derive the current value and when the business model of the entity is not to hold till maturity, it is at fair value. The timing is understood by the presentation of contractual cash flows as disclosed in notes to accounts. The uncertainty factor is somewhat countered by the fair valuation model by presenting the current value as on reporting date and for held to maturity securities which qualify SPPI test, are already at amortized cost which approximated their fair value.

Question 2 **Business model for managing financial assets**

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

Comment The business model test provides how an entity manages its financial assets so as to generate or realize cash flows. There are three types of model given i.e. Amortized Cost, FVTPL, FVTOCI. In some cases, the problem lies in classification of instruments between FVTOCI and FVTPL since sometimes there appears to be a thin line of difference between the two. Though this assessment is not merely based on management assertions but other factors also need to be considered such as how the entity's performance is evaluated and reported to key managerial personnel, the risks relevant to performance of business model (market fluctuations, etc.), how the returns from these types of assets are earned by the entity, etc. The business model cannot be governed just by the history or trends of the Company. So, sometimes, it becomes very difficult for auditors to differentiate the same. Also, regarding amortized cost model, the cash flows and the maturity period are sometimes are not clear and are not governed by formal agreements, in that case, it becomes difficult to apply the amortized cost model.

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

Comment The business model assessment may be applied consistently until the intention and purpose of holding the financial asset changes, if there is any such change, reclassification requirements are there. The changes are not so frequent and reclassification requirements are rare. So, the business model assessment is normally applied consistently.

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

Comment It becomes really important to analyze the business model since the equity instruments and debt instruments have different treatment. For debt instrument meeting the prescribed criteria, FVTOCI categorization is mandatory, just it can be classified as FVTPL only in limited circumstances. While in case of equity instruments, FVTOCI categorization is optional for instruments which are not held for trading. Since the financial statements are prepared for stakeholders at large, it makes difficult for end users, i.e. public at large who invests in company to understand. Yet, the business model test has played important role, the same can be elaborated and further implementation guidance can be provided.

Question 3 **Contractual cash flow characteristics**

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

Comment Contractual cash flow test is whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI). Only financial assets with SPPI cash flows are eligible for measurement using amortized cost or fair value through OCI, subject to the business model in which the asset is held.

The assessment of cash flow characteristics seems to be fine considering the approach taken by the companies.

Regarding the Financial instruments with sustainability-linked features, the same test needs to be applied and be classified at amortized cost or FVTOCI, subject to business model test, until it satisfies the SPPI test. There can be changes in cash flows considering the variations in cash flows, the modification in cash flows would be there and be dealt with but the same should represent SPPI test. Also, the SPPI test includes the variations due to market fluctuations and appropriate adjustment can be done.

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

Comment The cash flow assessment can be applied consistently though there may be modifications in terms of instruments from time to time and modifications need to be dealt with.

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

Comment The effects of cash flow characteristics seems to be in line with the intention behind it. A explicit guidance for new type of instruments related be given since Sustainability Reporting (SR) is coming and going to get implemented very soon in many countries.

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?**

Comment The investment in equity instruments is normally classified as FVTPL while IFRS provides an option to present it as FVTOCI. The equity investment is done by companies as general investment to generate returns and also as a strategic investment for long term purposes. If the Company records the same at FVTPL, the gains or losses upon fair valuation are directly recognized in profit or loss on year on year basis but at the same time, it provides a big opportunity for earnings management. This is not the actual performance of the entity if it is held as strategic investment and hence should not be classified at FVTPL.

The approach to classification at FVTOCI and that too as items not reclassified to profit or loss seems fine but this is an option and is not to be mandatorily applied. So, there comes a challenge for the users to understand the two entities when both have applied the different principles of recognition and may be difficult for users to understand. A thought should be given to make it mandatory in case of strategic investment. Also, upon derecognition of financial assets (equity instruments), the gain or loss for that year is recognized in profit or loss, a thought should be given to the same for these type of investments.

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

Comment The entities normally elect this option when the equity instruments are held as strategic investment and the equity instruments do not directly represent the performance of the entity.

(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?**

Comment The option to designate equity instruments at FVTOCI should be thought in terms of comments stated above in Question 4(a).

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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?**

Comment The presentation of effects of own credit in OCI seems fine since the fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit).
The effects of own credit is not to be presented directly as part of entity's performance, otherwise it will provide inappropriate understanding of company's position.
When the entity's credit quality declines, the value of its liabilities fall and gain is to be recognized and vice versa, the effects to be recorded in OCI.

(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)?**

Comment The approach to financial liabilities seems fine.

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?**

Comment The modification to contractual cash flows is recognized using two approaches being modification accounting and extinguishment accounting considering the change being more than or less than 10%. The same should be explicitly defined in the standard. The approach seems fine.

(b) **Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?**

Comment Yes, the approach can be applied consistently and the modification can result in derecognition of existing asset/ liability and recognizing a new asset/ liability if the changes are substantial in nature i.e. more than 10%.

Question 7 **Amortized cost and the effective interest method**

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

Comment The effective interest method discounts the estimated future cash flows and reflects the present value of the items as on date. Amortized cost is applied upon satisfying both contractual cash flow and business model test. The disclosures in financial statements also stated the contractual cash flows involved in future period. The difference of present value and the actual amount is recognized as finance cost or other income. The finance cost represent the financing expense of the company and other income represent the additional income other than from revenue from operations. Thus, this method provides the required useful information about the nature, timing and future cash flows to the users of financial statements.

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

Comment The effective interest method can be applied consistently but there can be need for modifications in future cash flows depending on the terms of agreement. The amortized cost is applied when business model test and contractual cash flow test is passed. In contractual cash flow test, whether the return represent only SPPI is in question. But since, the effective interest method is also required to include the changes relating to modifications, changes in market rates, etc., there can be changes in terms of agreement and accordingly contractual cash flows may change but the same would continue to pass the SPPI test and be recognized as modification in cash flows. The amortized cost can be applied consistently.

Question 8 **Transition**

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

Comment The transition requirements provides mandatory and voluntary exceptions to be applied in classification, measurement and recognition of financial instruments. The opening effects of financial instruments are recognized on date of transition and the financial instrument is carried at the new adjusted amount and difference be adjusted in Statement of changes in equity. This approach has simplified the process of adoption and also provides users with the relevant information to understand the financial statements.

(b) **Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?**

Comment The assessment of financial instruments issued longer back can sometimes have difficulty in assessment of instruments as to business model and contractual cash flow test, rest the IFRS provides transition requirements in detail and seems fine.

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?**

Comment The disclosure requirements under the standard should be examined as to whether they are able to fulfill the end user expectations and they should be elaborated further or revised as per user expectations.

(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?**

Comment The Board's standard setting approach seems fine. It also includes the views of preparers of financial statements, auditors, regulators, users, etc.