Addendum: Post Implementation Review: IFRS 9 *Financial Instruments* – Classification & Measurement: Draft Comment Letter

Background

1. Subsequent to publication of the December board papers the secretariat has received further feedback on an issue which may be significant to UK stakeholders. Given the project timeline we have created this addendum so that the issue can be considered in by the UKEB at its December 2021 meeting as part of its consideration of the draft comment letter to the IASB. This addendum sets out the issue and asks Board members whether it should be included in the draft comment letter published for public consultation. The questions for the Board in relation to this addendum are set out in paragraphs 7-9 of this paper.

The effective interest rate methodology

2. When calculating the effective interest rate on initial recognition, IFRS 9 requires an entity to estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options). For subsequent measurement, FRS 9 paragraphs B5.4.5 and B5.4.6 set out how an entity accounts for changes in estimated future cash flows.
    a. Paragraph B5.4.5 applies to floating-rate instruments and requires periodic re-estimation of the effective interest rate to reflect movements in the market rates of interest. This results in a re-estimate of the EIR with no immediate effect in profit or loss.
    b. Paragraph B5.4.6 applies to changes in estimates in all other circumstances. The entity continues to apply the original effective interest rate, resulting in an adjustment to the gross carrying amount of the financial instrument and an immediate effect in profit or loss (the 'catch-up' adjustment).
3. Some stakeholders believe that the application guidance is not sufficiently clear, and the application of B5.4.5 may be unnecessarily narrow. Terms such as floating rate or market rate may benefit from further definition or examples to provide clarity.
4. In June 2021 the IFRS Interpretations Committee (IFRIC) considered a question as to how to account for the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTROs[1]). These instruments include a feature where the interest rate may vary on a predetermined basis, based on the occurrence of one or more predetermined events. IFRIC concluded that considering how to reflect conditions attached to the interest rate in calculating the EIR is a broader issue which should be considered as part of the PIR of IFRS 9.

[1] TLTRO III Transactions (IFRS 9 Financial Instruments and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance), IFRIC, Tentative Agenda Decision, June 2021

5. The IFRIC decision is not an isolated example. Many loans have similar ratchet structures, including ESG lending. If, as a consequence of the PIR, more ESG instruments achieve amortised cost accounting, then having a framework which provides clear guidance on accounting for interest is desirable and could be seen as a holistic part of the ESG issue.

Revised Draft Comment Letter wording

6. Should the Board decide to include this issue in the Draft Comment Letter we suggest the wording below, which would become paragraphs A12-A13 of that letter. References in the comment letter to two significant UK issues would be amended to refer to three significant UK issues.

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.

A12. It is not always clear how uncertain cashflows should best be reflected in the EIR calculation, and specifically in which circumstances paragraphs B5.4.5 and B5.4.6 should be applied. This was illustrated in the recent IFRS Interpretations Committee TLTRO[2] decision, which considered an instrument where credit spread is increased following a scale of predetermined rates, on the occurrence of one or more predetermined events. This is not an isolated example as such ratchet structures feature in other financial instruments, including many financial instruments with ESG features (FIEF).

A13. We recommend the IASB provides further guidance on key terms such as "floating rate" and "market rate" to assist in understanding better the boundary between situations qualifying for paragraph B5.4.5 treatment and those to which B5.4.6 applies. Further examples, particularly those involving FEIF, would be helpful. In paragraph A8 we recommend removing the issue related to ESG instruments from the PIR and addressing it via a more urgent mechanism. We make the same recommendation in relation to this matter, as if more FIEF achieve amortised cost accounting treatment a clear understanding of the application of the EIR requirements to such instruments will be required.

Questions for the Board
7. Does the Board agree this issue should be included in the Draft Comment Letter?

[2] TLTRO III Transactions (IFRS 9 Financial Instruments and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance), IFRIC, Tentative Agenda Decision, June 2021

8. If the ESG issue is addressed by the IASB in a more urgent project than the PIR, does the Board believe the EIR issue should also be included in that more urgent project?
9. Does the Board approve the paragraphs labelled A12-A13 above for incorporation in the UKEB's Draft Comment Letter prior to its publication for stakeholder consultation?