**Our Ref.: C/FRSC**

**Sent electronically through the IASB Website (www.ifrs.org)**

13 January 2022

Dr Andreas Barckow
International Accounting Standards Board
Columbus Building
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Canary Wharf
London E14 4HD
United Kingdom

Dear Andreas,

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

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants in Hong Kong. We are grateful for the opportunity to provide our comments on this Request for Information (RFI).

The HKICPA has carefully reviewed the RFI and performed outreach with local stakeholders to seek feedback. We provide detailed comments in the Appendix, and summarise our primary observations and recommendations below.

Modifications to contractual cash flows
We have significant concerns regarding the modification requirements in IFRS 9. We consider that they are not working as intended to create consistency in accounting. In particular, IFRS 9 is not clear as to what constitutes a modification in financial instruments, and when and how to apply the modification requirements. In addition, we question whether the existing modification requirements on solely a quantitative basis for financial liabilities (i.e. the 10% test) would be able to fully capture the changes in risk profile as a result of renegotiation or modification, and hence provide useful information to users in all circumstances. We also believe that the concept of a substantial modification should be included in the derecognition criteria for financial assets.

We consider that this is an important and urgent issue that the IASB should address expeditiously, given the increasing number of debt restructurings as a result of the Covid-19 pandemic and interest rate benchmark reform. We also note that the issues on modifications are broad in scope, and cover both the conceptual rationale for and the practical application of the existing requirements. In this regard, we strongly recommend that the IASB carry out a fundamental and thorough review of the modification requirements in IFRS 9 in a separate project to address this matter holistically.

Amortised cost and the effective interest method
We noted several issues on the application of the effective interest method and recommend that the IASB provide guidance or clarification on how the relevant requirements in IFRS 9 should be applied. These issues include:

- How to determine future cash flows that are subject to conditions or contingent events;

- Application of IFRS 9.5.4.3, IFRS 9.B5.4.5, and IFRS 9.B5.4.6: What constitutes a floating-rate instrument and under which circumstances should IFRS 9.5.4.3, IFRS 9.B5.4.5, or IFRS 9.B5.4.6 apply?
- Estimation of expected cash flows: whether it should be based on the most likely scenario or be a probability weighted average; and
- How to determine the effective interest rate for interest-free related party loans and trade receivables without significant financing components.

Sustainability-linked financial instruments

We understand the IASB's intention to align the classification and measurement of the financial assets with how entities manage them and the contractual cash flows characteristics of the instruments. However, challenges were noted in applying the relevant requirements to emerging and complex financial instruments. In particular, we noted that financial instruments with sustainability-linked features are becoming prevalent in Hong Kong and Mainland China, and there are different views on how the solely payments of principal and interest (SPPI) test should be applied to these instruments. Accordingly, we recommend that the IASB carry out standard-setting activities on this area, including clarifying how the existing requirements should be applied to sustainability-linked financial instruments, considering whether the accounting outcomes would be appropriate, and working closely with the International Sustainability Standards Board (ISSB) on setting useful and relevant disclosure requirements.

If you have any questions regarding the matters raised in this letter, please contact me (ceciliakwei@hkicpa.org.hk), Joni Kan (jonikan@hkicpa.org.hk) or Carmen Ho (carmenho@hkicpa.org.hk), Associate Directors of the Standard Setting Department.

Sincerely,

Cecilia Kwei
Director, Standard Setting Department

**<u>Work undertaken by the HKICPA in forming its views:</u>**

The HKICPA:

(a) issued an Invitation to Comment on the RFI on 4 October 2021 to its members and other stakeholders;

(b) sought input from its Financial Instruments Advisory Panel and Small and Medium Practices Committee and its Working Group on Technical Issues, which are mainly comprised of technical and industry experts from large as well as small and medium accounting firms (collectively, Practitioners);

(c) held a public roundtable discussion for local stakeholders, including investors, analysts, preparers and practitioners on 16 November 2021;

(d) consulted its Quality Assurance Department and reviewed its practice review findings; and

(e) developed its views through its Financial Reporting Standards Committee, having reflected on its respondents' views. The Committee comprises academics, preparer representatives from various industry sectors, regulators, as well as technical and industry experts from small, medium and large accounting firms.

**<u>Detailed comments on the IASB RFI</u>**

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

1. The HKICPA and its respondents considered that the business model assessment in IFRS 9 is generally working as intended.

2. Nevertheless, practical challenges were noted in complex situations and diversity in practice exists. We recommend that the IASB provide guidance and/or clarification on applying the business model assessment to the following situations:

   (a) Due to the recent changes in business and economic environment as a result of the Covid-19 pandemic, there has been an increase in the frequency and value of sales of financial assets that are categorised within a 'hold to collect' (HTC) business model. Questions arise as to whether and how such unexpected increase in frequency and value of sales would affect the business model assessment of financial assets, including the existing financial assets and those that will be subsequently purchased.

   Some respondents noted that IFRS 9.B4.1.2B-B4.1.3B provide certain guidance, but considered that it is not clear how to apply those guidance to the above situations, specifically whether the accounting treatment should reflect how an entity <u>*would manage*</u> the financial assets (as specified in IFRS 9.B4.1.2B), or how an entity <u>*actually managed*</u> its financial assets as evidenced by actual sales (as specified in IFRS 9.B4.1.2C). Accordingly, we recommend that the IASB clarify the interaction between IFRS 9.B4.1.2B and B4.1.2C, e.g. whether IFRS 9.B4.1.2B takes precedence over IFRS 9.B4.1.2C and whether the latter paragraph only provides indicators to assist the assessment required in IFRS 9.B4.1.2B.

   (b) Many respondents noted that bills discounting and factoring of trade receivables are common in Mainland China and Hong Kong, and diversity in practice exists in assessing the business models for these financial assets. For example, an entity factors a portion of its trade receivables to a bank and receives cash in advance of settlement by its customers. Questions arise as to whether such arrangement would be regarded as a "sale" of the trade

receivables for the purpose of business model assessment, and whether this would prohibit the receivables, including those that are not factored, from categorising within the HTC business model. Some respondents considered that measuring trade receivables at fair value would not provide useful information to users of financial statements because these receivables are derived from normal business operation. In this regard, we recommend that the IASB provide guidance on how the business model assessment should be applied to discounted/factored receivables and whether the conclusion would be different if entities factor their receivables with or without recourse.

(c) Respondents in the banking industry considered that the language in IFRS 9.B4.4.3(c) is unclear as to whether and how an internal transfer of financial assets between group companies or within an entity would affect the business model assessment in the following situations, and suggested that the IASB clarify the requirement.

(i) Internal transfers of financial assets between parts of an entity or within a group with different business models is common in the banking industry, e.g. a sale of a financial asset from an investment desk (i.e. HTC business model) to a trading desk. Respondents considered that the financial statements of the entity and the group should reflect the change in how the financial assets are managed going forward. However, IFRS 9.B4.4.3(c) seems to suggest that such transfer is not a change in business model.

(ii) An entity undergoes an internal restructuring where it merges one business model with another to form a new combined business model. Questions arise as to whether and how such restructuring would affect the business model assessment of the transferred financial assets and those acquired after the restructuring.

(d) Some respondents considered that the interaction between the business model assessment, the SPPI test and the derecognition requirements is unclear. In particular, they noted that the derecognition requirements in IFRS 9.3.2.2 could be applied to a part of a financial asset (with specifically identified cash flows) and questioned whether the business model assessment and the SPPI test could also be applied to a portion of a financial asset that is not legally separable[1]. Examples include a trade receivable with a portion that has sub-participation rights, and a syndicated loan partly held to collect contractual cash flows and partly held for sale. We suggest that the IASB clarify the unit of account for the business model and SPPI assessments in these cases.

**Question 3: Contractual cash flows characteristics**

3. The HKICPA considers that the SPPI test is generally working as intended for most situations. However, challenges were encountered in applying the SPPI test to emerging and complex financial instruments, e.g. financial instruments with sustainability-linked features and contractually-linked instruments (CLIs).

*Sustainability-linked features*

4. We and our respondents noted that financial instruments with sustainability-linked features are becoming prevalent in Hong Kong and Mainland China. There are many types of financial instruments with sustainability-linked features, and differing

[1] Other than hybrid contracts with financial asset hosts that are required by IFRS 9 to be classified and measured in their entirety.

views on how the SPPI test should be applied to these instruments are noted. For example, for financial assets with interest rate adjustments linked to environmental, social and governance (ESG) targets, some took the view that these instruments could be SPPI compatible because the predominant features might represent consideration for the credit risk of the financial assets or a profit margin, or those features have a de minimis impact on cash flows. However, the application of judgement on these and other factors has led to different outcomes given the same facts and circumstances.

5. Some respondents noted that entities often hold financial instruments with sustainability-linked features to collect contractual cash flows (i.e. within the HTC business model). Measuring these instruments at fair value through profit or loss (FVTPL) would not align with how entities manage their financial assets and therefore, would not provide useful information to users.

6. If the IASB would like to promote sustainability-linked financial assets by allowing them to be measured at amortised cost, a few respondents suggested the IASB consider either:

   (a) incorporating an exception for sustainability-linked financial assets, similar to the exception for regulated interest rates in IFRS 9.B4.1.9E; or

   (b) adding requirements similar to those on modified time value of money element in IFRS 9.B4.1.9B-B4.1.9D.

   However, these respondents acknowledged the difficulties in defining sustainability-linked financial instruments that should be within the scope of the above suggestions given the various types of such instruments in the market.

7. In light of the above, we recommend that the IASB carry out standard-setting activities on sustainability-linked financial instruments, including:

   (a) clarifying how the SPPI test should be applied to these financial assets and considering whether the accounting outcomes would provide useful information to users; and

   (b) adding disclosures about sustainability-linked financial instruments, e.g. significant contractual terms and the potential impact of the instruments on the entities' cash flows. On this note, we also suggest that the IASB work closely with the ISSB on how the accounting disclosures would interact with the sustainability disclosures in order to provide users with comprehensive and relevant information.

*Contractually-linked instruments*

8. The HKICPA observed that it is generally challenging to apply the CLI requirements due to the complexity of CLI structures.

9. A few respondents noted that there are cases where the senior tranche note of CLIs and non-recourse arrangements might achieve economically similar results, yet IFRS 9 sets out different requirements for CLIs (IFRS 9.B4.1.21) and non-recourse arrangements (IFRS 9.B4.1.17) when applying the SPPI test, which could result in different accounting outcomes.

   For example, a special purpose entity issues different tranches of notes with credit concentrations such that there is a waterfall structure which falls within the scope

of CLIs. The underlying pool of investments include both financial and non-financial instruments that do not all meet the SPPI test. The senior tranche note has contractual terms that indicate the holders should receive principal plus interest on the amount outstanding. Applying the CLI requirements, the senior tranche note does not meet the SPPI test because the underlying pool of investments include instruments that do not fulfil SPPI (i.e. fail IFRS 9.B4.1.21(b)). However, for an instrument that is structured as a non-recourse loan with payments ring-fenced to the amount received from the underlying investments, in which the economic returns are similar to the senior tranche note as described above, applying the non-recourse requirements the loan may meet the SPPI test.

10. Given the above, we recommend that the IASB clarify whether such differences in accounting outcomes for economically similar situations are intended, and provide examples to illustrate how to apply the relevant requirements in those cases for consistent application.

**Question 4: Equity instruments and other comprehensive income**

11. Our respondents generally welcome the measurement option in IFRS 9.5.7.5 because presenting fair value changes on investments in equity instruments that are not held for trading in other comprehensive income (OCI), instead of profit or loss, would not distort the financial performance of the entities and would allow users to identify easily the associated fair value changes.

12. A majority of our respondents considered that the prohibition from recycling gains and losses presented in OCI to profit or loss upon disposal of the equity investments is appropriate, while a small minority considered that such a prohibition does not reflect the true performance of the entities and negatively affects the performance evaluation and incentives of management.

    The HKICPA agrees with the IASB's views and its rationale as explained in IFRS 9.BC5.25(b) and the RFI for the prohibition from recycling gains and losses on disposal. In particular, recycling OCI balances to profit or loss would impose on entities the need to assess the impairment of equity instruments. Such assessment created significant application issues for entities applying IAS 39 *Financial Instruments: Recognition and Measurement* in the past. In addition, there is no new evidence to support the reintroduction of recycling OCI balances to profit or loss upon the disposal of equity investments.

**Question 5: Financial liabilities and own credit**

13. The HKICPA generally considered that the requirement for presenting the fair value changes of a financial liability that is attributable to changes in its own credit risk in OCI is operating as intended for financial institutions and is a welcome change from IAS 39.

14. Nevertheless, many respondents shared that there are significant practical difficulties for non-financial institutions (or corporates) to determine the change in fair value of an entity's own credit risk.

    (a) In general, corporates do not have the same valuation capabilities as financial institutions to measure their own credit risk.

    (b) The measurement method provided in IFRS 9.B5.7.18 only applies to simple instruments with fixed rate and terms, but not for complex financial instruments,

e,g, hybrid instruments with embedded derivatives. Some corporates use the alternative method in IFRS 9.B5.7.16(b); however, such method is difficult to apply in practice because corporates often do not have observable credit risk data for these instruments.

(c) Corporates often use the FVTPL option in IFRS 9.4.3.5 to avoid the complexity of bifurcating hybrid instruments with embedded derivatives; however, the requirement to separately account for credit risk puts the corporates back into a position where they need to separately account for components of financial liabilities which defeats the purpose of the FVTPL option in the first place.

15. In view of the above concerns, some respondents suggested the IASB consider providing an option for entities to choose to apply the accounting requirements in IFRS 9.5.7.7. Some suggested that the IASB provide examples illustrating how to measure changes in own credit risk in complex situations such as hybrid instruments.

16. We acknowledge our respondents' concerns regarding the practical challenges of presenting changes in own credit. While we agree with our respondents' suggestion of making the accounting requirements in IFRS 9.5.7.7 optional, we consider that such option should be limited to only those entities that have applied the FVTPL designation option for embedded derivative in IFRS 9.4.3.5 because of the complexity of bifurcating hybrid instruments as stated in paragraph 14(c) above. We consider that entities who have designated their financial liabilities at FVTPL under IFRS 9.4.2.2 should generally be able to present the effects of own credit in OCI because they manage and evaluate their financial liabilities on a fair value basis, and should have the relevant valuation capabilities.

**Question 6: Modifications to contractual cash flows**

17. The HKICPA and its respondents consider that the modification requirements are not working as intended to ensure consistency, and note significant concerns and debate in this area. The following application issues and questions are noted:

(a) IFRS 9 is unclear as to what constitutes a modification of financial instruments, i.e., whether it refers to changes in ***contractual terms*** of the financial instruments, or changes in ***contractual cash flows***. Some respondents shared that before the Interest Rate Benchmark Reform (IBOR Reform) project, entities normally consider that changes in contractual terms constitute a modification. However, the IBOR Reform project discussions seemed to broaden modification to the exercise of existing clauses in the contracts, which caused further confusion about what a modification is.

(b) In applying the modification requirements in IFRS 9, we have questions on:

(i) Whether a qualitative test could (or should) be applied in addition to the 10% test for financial liabilities. Some respondents considered that applying the 10% test alone may not capture the change in characteristics of the risks associated with the instruments in certain situations. For example, changing the currency of the debt (e.g. from RMB to HKD), or restructuring the payment terms (e.g. from cash to partial shares settlement), or switching interest rates (e.g. from floating to fixed) could change the risk profile. Therefore, specific facts and circumstances and qualitative factors should be considered in addition to performing the quantitative test.

(ii) Whether the 10% test in IFRS 9.B3.3.6 could be applied by analogy to financial assets. Some respondents noted that because IFRS 9 is not clear on when derecognition arises for renegotiated / modified financial assets, most companies develop their own accounting policies, e.g. by referring to the 10% rule for financial liabilities and/or introducing different qualitative factors. However, it is not clear how these factors are incorporated into the test based on reviewing companies' accounting policies. In addition, the increasing number of debt restructurings due to the IBOR Reform and negotiated payment holidays as a result of Covid-19 create additional complexity and diversity in this area.

(iii) When to apply IFRS 9.B5.4.6 to recalculate the carrying amount of the financial instruments or apply IFRS 9 B5.4.5 (see the related comments in paragraph 19(a) below).

18. We consider that IFRS 9 is not sufficiently clear on when and how to apply the modification requirements. We question whether the existing requirements (i.e. the 10% test alone) would be able to fully capture the changes in the risk profile as a result of a modification of a financial liability, and hence provide useful information to users in all circumstances. In reconsidering the modification accounting requirements for financial assets, we would also suggest that the IASB include the concept of a substantial modification in the derecognition criteria for financial assets, similar to that for a financial liability.

    We consider that the concerns and issues on modification requirements are broad in scope, and cover both the conceptual rationale for and the practical application of the existing requirements in IFRS 9. In this regard, we strongly recommend that the IASB carry out a fundamental and thorough review of the modification requirements in IFRS 9 in a separate project to address this matter holistically.

**Question 7: Amortised cost and the effective interest method**

19. We and our respondents noted that the following application issues / questions, and recommend that the IASB provide guidance or clarification on how the requirements should be applied.

    (a) *Application of IFRS 9.5.4.3, IFRS 9.B5.4.5, and IFRS 9.B5.4.6*
    We observed diversity in practice in the application of IFRS 9.5.4.3, IFRS 9.B5.4.5, and IFRS 9.B5.4.6 due to the lack of clarity on the scope and definition of what constitutes a floating rate instrument under IFRS 9.B5.4.5. The following examples were shared by respondents:

    (i) *Loans with ratchet feature*
    Fixed rate loans sometimes include a ratchet feature in which different fixed interest rates would apply depending on whether specified financial covenants are met. When such a change in interest rate occurs, a question arises as to whether an entity should apply IFRS 9.B5.4.6 and remeasure the loan using the original effective interest rate, or whether the entity could apply IFRS 9.B5.4.5 to reset the effective interest rate (EIR) of the loan by viewing the ratchet feature as a floating element in the original loan agreement to reflect movements in market interest rates to compensate for the increased credit risk associated with the loan.

(ii) *Modification of loans prepayable by the borrowers*
For loans that are prepayable at principal plus interests at the option of the borrowers, it is common that borrowers would negotiate with the lenders for a lower interest rate (e.g. to reset the interest to market) when market interest rates decline. Questions arise as to whether such changes could be considered as "reflecting the movements in the market rates of interest" under IFRS 9.B5.4.5, given that the original term of the loan includes a prepayment feature (i.e. the lender anticipated such a modification – either reduce rate or lose business), or whether IFRS 9.5.4.3 should be applied. Some respondents considered that applying IFRS 9.5.4.3, an entity might need to recognise a significant adjustment in profit or loss which may not reflect the economic substance of the transaction nor provide useful information to users in these cases, as the rate is adjusted in response to market interest rate changes.

We consider that it is practically challenging to assess when to apply IFRS 9.5.4.3, IFRS 9.B5.4.5, and IFRS 9.B5.4.6. Therefore, we recommend that the IASB clarify what a floating rate instrument is and provide illustrative examples on the application of paragraphs IFRS 9.5.4.3, IFRS 9.B5.4.5, and IFRS 9.B5.4.6 to enhance consistent application.

(b) *Cash flows subject to conditions or contingent events*
Most respondents noted differing views on how future cash flows that are subject to conditions or contingent events affect the determination of the EIR assuming amortised cost measurement is appropriate for the instrument. For example, in cases where instruments have prepayment options or ESG-linked features, some consider that the EIR (both at initial recognition and subsequently) should reflect an assessment of whether the entity will exercise these options or meet the targets. Others are of the view that entities should apply IFRS 9.B5.4.6 and recognise a catch-up adjustment upon the occurrence of the events. Preparers from the banking industry also shared that in practice, banks would not adjust the cash flows for ESG features unless the event has been triggered as they cannot reliably measure the probability of events occurring.

In view of the mixed views expressed and operational complexities associated with incorporating conditions and contingent events in the calculation of EIR, we recommend that the IASB clarify how to apply the effective interest method to future cash flows that are subject to conditions and contingent events.

(c) *Estimation of the expected cash flows applying the effective interest method*
Some respondents noted that IFRS 9.5.5.17 requires expected credit losses to be calculated based on an unbiased and probability weighted amount. However, IFRS 9 does not specify how the expected cash flows are estimated applying the effective interest method (i.e. whether it should be based on the most likely scenario or be based on a probability-weighted average). Hence, we recommend that the IASB clarify how expected cash flows should be estimated in order to enhance consistent application across entities.

(d) *Interest-free related party loans and trade receivables without significant financing components*
We noted that for interest-free related party loans that are repayable on demand, practices have been developed to apply a zero EIR to these instruments. This is because applying the definition of EIR, the fair value of the loans on initial recognition is the amount repayable on demand which equals the full nominal value of the loan (even though the estimated cash flows in the

EIR calculation are only *expected* to be received in the future). For trade receivables without significant financing component, entities apply IFRS 9.5.1.3 which requires them to measure such trade receivables at their transaction price, again resulting in a zero EIR. However, respondents generally considered that measuring these instruments at face value without discounting does not reflect the time value of money and reduces the information value of recognised expected credit losses. Hence, we suggest that the IASB clarify this matter as these instruments are very common in Hong Kong.

(e) *Extension option in a fixed-rate debt instrument*
We noted that the IFRS Interpretations Committee (IC) discussed an application question regarding the accounting for an extension option in a fixed-rate debt instrument at its March 2012 meeting[2]. Specifically, the question is whether the extension option should be separated and accounted for as a derivative, or be treated as an embedded loan commitment that is outside the scope of IFRS 9. We noted that this issue was not addressed by the IC at that time, and therefore suggest that the IASB clarify the accounting for such instruments.

**~ End ~**

[2] https://www.ifrs.org/content/dam/ifrs/meetings/2012/march/interpretations-committee/111203ap11ias39termextendingoptionsindebthostcontracts.pdf