COMITÊ DE PRONUNCIAMENTOS CONTÁBEIS

SAS Quadra 05. Bloco J. CFC
Brasília, Distrito Federal – Brazil
http://www.cpc.org.br

January 27, 2022

commentletters@ifrs.org

IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London

Reference: Post-implementation Review of IFRS 9: Classification and Measurement

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] welcomes the opportunity to comment on the Request for Information and comment letters: Post-implementation Review of IFRS 9—Classification and Measurement.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Rogério Lopes Mota
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)

[1]The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), B3 (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

In determining the views of the Brazilian Accounting Pronouncements Committee as to the matter, we have performed outreaches with preparers of financial statements of Brazilian public entities and members of the CPC. We summarized our comments and observations based on our discussion in subtopics below, consistent with the sequence of information provided by the RFI:

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.

Our response:

In our view and, based on the feedback received in the outreaches conducted in our jurisdiction, the classification and measurement requirements set forth by IFRS 9 have been welcomed by the preparers of the financial statements. While significant changes have not been noted for a large group of entities (especially those where financial assets are mostly represented by financial assets measured at amortised cost) the changes allowed, in our view, for a better depiction of the nature of the financial assets given their respective contractual cash flow characteristics as well as management's business purpose when managing such financial assets. As a consequence, in our view, the revised classification and measurement principles also provides users of financial statements with more useful and consistent information about the amount, timing and uncertainty of the entity's future cash flows.

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's 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).

Our response:

Question 2 (a)

We support the business model as a basis for accounting as in our view, this maximises the link between the accounting for the financial instruments and the economic substance of the financial transactions as reported by the entities in their financial statements. We do, however, have views on specific items that we believe could be assessed and improved as commented below and also on items (b) and (c), below.

However, according to IFRS 9, the classification of financial assets on the basis of the entity's business model for managing the financial assets is determined by the entity's key management personnel (as defined in IAS 24, Related Party Disclosures) at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. Further discussion provided by IFRS and, as well as the Basis for Conclusion indicate that a certain level of

governance and formalisation of certain documents indicating the entity's business model for collecting the cash flows arising from such financial assets.

Feedback received from respondents indicated that not all entities that apply IFRS (i) have robust governance and/or documentation regarding their business models for collecting cash flows from such financial assets; or (ii) recognise financial assets that are not clearly under the scope of a specific classification (i.e., amortised cost). Some of those entities (especially non-public and non-financial entities) no not have sophisticated and/or strict policies or documentation that formally determines how their financial assets are managed.

We note that, consistent with IFRS 9.B4.1.2B, an entity's business model for managing the financial assets is viewed as a matter of fact and typically observable through particular activities that the entity undertakes to achieve its objectives. However, the standard also determines that judgment is necessary whenever the business model is not determined by a single factor or activity (and, as such, the entity would consider all relevant and objective evidence that is available at the date of the assessment).

According to the respondents, those entities (i.e., not listed entities) would benefit from a simplification for, for example, removing the requirement to determine how financial assets should be classified and measured on the basis of the entity's business model for managing the financial asset (similar to the simplification discussed on paragraph B32 of the Request for Information on the Comprehensive Review of the IFRS for SMEs Standard, published in January 2020). In our view, and consistent with the views provided in the January 2020 RFI mentioned above, such simplifications if made available would not preclude and entity from faithfully representing the financial assets in according to IFRS principles when the business model assessment is unlikely to significantly affect the classification of financial assets held by such entities (which in most cases may not comply with the criteria for being an SME but are exposed to similar financial instruments).

Questions 2 (b) and (c)

a. Business models that are dynamic in nature

As discussed in the RFI, changes in the classification and measurement of financial assets subsequent to initial recognition have the potential to make financial statements more difficult to understand as they affect comparability. As such, according to the Board, any reclassification would only occur upon the occurrence of a significant event.

In our view and, consistent with feedback received from respondents, the business model may be at times more dynamic for certain entities and less infrequent. Entities in certain industries (i.e., financial institutions) may eventually develop new products that, while similar to other products previously classified in

another group of financial assets may be more consistent with another classification. Entities may also reformulate their products, policies and business model in response to developments that affect the entity 's projected cash flows from the asset. Entities may, for example, switch to the process of anticipating receivables more often than usual when cash is needed even though those financial assets were deemed to be part of an entity's process of managing those assets to collect solely principal and interest.

In that regard, entities withing the banking industry in our jurisdiction, for example, have commented that the definition of the business model applicable to loans provided is not trivial. While in certain situations the intent to hold an instrument until maturity may be clear, in a significant portion of the operations, the decision to sell an asset may be based on current facts and circumstances assessed by the financial institution at a certain time, considering, among others, the need to balance assets and liabilities as well as the quantity and quality of regulatory capital. In those respondents' views, if such dynamic is not taken into consideration in the standard, there can be a risk that entities may be questioned and demanded including by regulators) to follow strictly a business model previously established rather than reflecting the actual nature of the entity's dynamic business model.

As such, in our views it would be beneficial if the Board could expand this discussion in the standard clarifying how those changes in the entity's management of the contractual cash flows that appear to be less infrequent (noting that while "infrequent" is referred to in the standards, IFRS 9 provides no guidance as to how this term should be interpreted) and not necessarily represent a significant event could be viewed on the basis of whether there is an actual change in the business model that would require the entity to review its previously assessed classification (or even how would it affect future classifications).

b. Loans provided by financial institutions and SPPI

A comment risen by a respondent from a financial institution suggested that while not passing the SPPI test, certain operations should be allowed to be subsequently measured at the amortised cost in instances where the business model does not consider realising the asset through sales. That would be the case when, for example, the financial assets are indexed to a more elevated percentage of in a rate (i.e., the Brazilian *SELIC*[2] rate, as commented on question 3(a), below) or to foreign currencies.

As financial institutions typically collect and borrow funds in foreign currencies, for example, in those respondents' views' ensuring that assets are recognised based on the amortised cost avoids inconsistencies among assets and liabilities without having to resort to the fair value option. In a country with a reasonable level of volatility in currency exchange such as Brazil, failure to consider these

[2] The basic interest tax defined by the Brazilian government and used by private and public banks as the reference for their own interest rates.

characteristics when performing the SPPI test may induce excessive volatility in the accounting results of financial instruments held for the purpose of receiving cash flows at the time of the contract. Classification as fair value through profit or loss anticipates the adjustment of future cash flow (and then can promote movement in the opposite direction), increasing the volatility of the accounting result. Those respondents see that It would be very interesting if more guidance on the matter were included in the accounting standard.

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).

Our response:

In our view certain challenges arise when assessing the contractual cash flows characteristics of a financial asset. We provide the views below:

a. Leverage-type features

IFRS 9 clarifies that when financial assets have contractual cash flows that are not solely payments of principal and interest, the instrument would fail the contractual cash flow characteristics test unless such feature is determined to be “de minimis” or “non-genuine”. This is associated with the concept of leverage as a contractual cash flow characteristic that increases the variability of the contractual cash flows with the result that they may be viewed as not having the economic characteristics of just principal and interest.

The interpretation of leverage in this context has raised concern from some respondents especially considering the volatility in interest rates noted during the pandemic as well as high inflation in certain markets. In Brazil, financial assets that have fixed maturity and payments of principal and interest are typically linked to an index that updates the value of the money over time based on a market interest rate and /or an inflation rate. In our view, linking the principal and interest payments to such index updates the time value of money to the current level so that the interest rate reflects the "real" interest rate. Thus, interest is compensation for the time value of money on the principal receivable and the financial asset would not fail the SPPI test. Respondents expressed concerns that the increase in the current levels of such indexes in the Brazilian environment (inflation is currently above 10% over the last year and the SELIC is currently at 7.5% per year) could be viewed as features that introduce leverage that increases the variability of the contractual cash flows, resulting in them not having the economic characteristics of interest (and, as such, would require those instruments to be measured at fair value through profit or loss consistent with IFRS 9.B4.1.9).

As such, we believe that providing additional guidance regarding as to how volatility in the markets may impact the SPPI test in such example would be beneficial for the entities.

b. Reasonable compensation

In the examples associated with an instrument with cash flows that are SPPI compliant, IFRS 9 (paragraph B4.1.11(b)) includes an instrument

In paragraph B4.1.11(b) of IFRS 9, one of the examples provided of instruments whose cash flows are 'solely payments of principal and interest' or 'SPPI', is an instrument with a contractual term that allows the issuer to prepay or permits the holder to put the instrument back to the issuer before maturity. The example states that the prepayment substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which could include reasonable compensation for the early termination of the contract.

We note that the term "reasonable compensation" is not defined in IFRS 9 or other standard and there is also no specific guidance on IFRS 9 addressing what would be a reasonable compensation. In our view, this judgment would also be subject to the specific facts and circumstances associated with a transaction (i.e., the economic nature of the contractual clause, enforceability, interpretation of Laws and other legal aspects in a jurisdiction) and the entity develops its own accounting policy to determine whether such compensation clauses provide for only reasonable compensation, which may lead to diversity in practice.

We suggest that the Board includes in the revised IFRS 9 a more extensive guidance relating to such prepayments and the basis that the preparer should consider when assessing the context included in the "reasonable compensation for the early termination of the contract" wording.

c. Financial instruments with sustainability-linked features

We believe that the IFRS 9 principles are restrictive as it relates to features that cause variability to cash flows expected from a financial asset, as discussed above. If such variation features are not consistent with the basic concept of SPPI, then the classification cost accounting is disqualified. As SPPI cash flows are typically those of a basic lending agreement, judgment is applied by the entities to determine whether such sustainability features, that typically include step-ups respond to, or provide compensation for, economic events that are not those of basic lending. Given the lack of guidance in that regard, further direction from the Board on the revised IFRS 9 would be beneficial for the entities.

For an issuer of a financial instrument with a sustainability-linked feature, we believe that the main judgment is whether the variability feature represents a separable embedded derivative (so that the entity has a host bond instrument that is typically subsequently measured at amortised cost and a derivative that is measured at fair value). Whether this would be required depends on whether the variability feature meets the definition of a derivative and is deemed to be closely related to the underlying risks in the bond. Also, we understand that certain features will not meet the definition of a derivative since the underlying variable

that drives the feature's value is, in certain arrangements, of non-financial nature and specific to the issuer of the financial instrument.

As such, we believe that current IFRS standards provide an adequate basis for an issuer of a financial instrument that includes a sustainability-linked feature to determine the proper classification and financial impacts that arise from the nature of the respective arrangement.

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).

Our response:

Based on the feedback received in the outreaches conducted in our jurisdiction, we note that the option has not been widely adopted by the entities. In our view, this may contradict the Board's views that the prohibition of recycling would result in more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, we have no further views regarding this topic.

Questions 5 and 6

For those questions we do not have any further comment or disagreement with the approach suggested by the Board.

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).

Our response:

We note that according to IFRS 9, for financial instruments that are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

Feedback received from entities within the banking industry have observed that in Brazil, those entities have utilised a simplified approach to determine the effective interest rate, where some entities have calculated the incremental costs incurred to give rise to the financial instrument and adding those costs to the related financial instrument in the statement of financial position with the respective entry in the statement of profit or loss. Also, other entities have recognised these expenditures directly in the statement of profit or loss when such amounts are deemed to be immaterial. In practical terms, the effects of transaction costs on the effective interest rate would then occur by portfolio and not by each instrument, individually. According to those respondents, providing a basis to adopt a simplified approach on a revised standard would be beneficial and would not preclude the entity from achieving fair presentation of the financial instruments in the financial statements.

Questions 8 and 9

For those questions we do not have any further comment or disagreement with the approach suggested by the Board.