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IFRS Developments

IASB's Exposure Draft of proposed amendments to the Classification and Measurement requirements of IFRS 9

What you need to know

- In March 2023, the IASB (International Accounting Standards Board) published an ED of proposed amendments to the IFRS 9 classification and measurement requirements, and IFRS 7 disclosures.
- The ED proposes amendments to the requirements to derecognise financial liabilities using an electronic payment system and to address the classification of financial assets with ESG features.
- Changes for non-recourse loans and contractually linked instruments are also proposed.
- Additional disclosures are proposed for financial instruments with contingent features, and for equity instruments classified at fair value through OCI.
- The comment period closes on 19 July 2023.

Introduction

On 21 March 2023, the International Accounting Standards Board (the IASB or the Board) published the Exposure Draft (ED), *Amendments to the Classification and Measurement of Financial Instruments*. The comment period closes on 19 July 2023. The proposals in the ED address two urgent issues:

- Settling financial liabilities using an electronic payment system; and
- Assessing the contractual cash flow characteristics of financial assets including those with environmental, social and governance (ESG)-linked features.

Amendments are also proposed for non-recourse assets and contractually linked instruments (CLI). In addition, disclosure changes are proposed for equity instruments at fair value through other comprehensive income (FVTOCI) and financial instruments with contractual terms that reference a contingent event. The IASB has published a *Snapshot* which summarises the ED.

The ED is the culmination of work to date on the post-implementation review (PIR) of IFRS 9 *Financial Instruments* with respect to the classification and measurement requirements. The purpose of the PIR is for the IASB to assess whether the effects of applying IFRS 9 for users of financial statements, preparers, auditors and regulators are as intended when IFRS 9 *Financial Instruments* was developed.

Prior to the ED, in September 2021, the IASB published a *Request for Information* (RFI); during 2022, it discussed responses to the RFI and, in December 2022, published the *Project Report and Feedback Statement*.

For a summary of these discussions and EY's views, see *Applying IFRS, IFRS 9 PIR Progress to date*.

How we see it

Given the urgency and importance of the issues the ED addresses, users and preparers of financial statements should, as a priority, carefully review the proposals and consider how they would be affected.

Building a better working world

Derecognition of financial assets and financial liabilities settled through electronic transfers

In September 2021, the IFRS Interpretations Committee (IFRS IC) was asked when a financial asset settled by a cash payment received via an electronic transfer system is derecognised. The discussion was extended to the derecognition of a financial liability settled by a payment made through an electronic transfer system.

The feedback to the IFRS IC identified diversity in practice for the timing of derecognition of financial assets and financial liabilities, not just those settled via an electronic transfer system, but also using other methods. This includes settlement by cheque, debit card and credit card. The issue is sufficiently material to require a change to IFRS 9 rather than an interpretation of existing IFRS 9 by the IFRS IC, so it was brought into the scope of the IFRS 9 PIR.

The approach proposed by the IASB in the ED comprises two elements.

- A clarification that for the date of initial recognition or derecognition of a financial asset or financial liability, an entity shall apply settlement date accounting. This means the financial asset or financial liability is not derecognised until the cash has arrived in the recipient's bank account and is available for their use.[1]
- For a financial liability settled in full, or in part, using an electronic payment system, an entity is permitted to make an accounting policy election to derecognise the liability before settlement date, if certain conditions are met.[2]

The first proposed amendment emphasises that the default treatment for the recognition and derecognition of financial assets and financial liabilities is settlement date accounting. This responds to the practice identified by the IFRS IC in some jurisdictions, whereby entities adjust cash balances at the reporting period end to reflect cash payments and receipts in-transit.[3] This affects the timing for the derecognition of the corresponding financial liabilities and financial assets. Entities would need to cease this practice when the amendments take effect.

The second proposed amendment addresses the specific scenario of payments made using an electronic payment system for financial liabilities. It does not apply to financial assets, for which only settlement date accounting is permitted nor does it apply to any other means of paying financial liabilities, such as payments by cheque, debit card or credit card. The conditions for a financial liability to be derecognised before settlement date are, as follows:

- The entity has no ability to withdraw, stop or cancel the payment instruction
- The entity has no practical ability to access the cash to be used for settlement as a result of the payment instruction
- The settlement risk associated with the electronic payment system is insignificant

Entities would make an accounting policy election to apply this treatment to all financial liabilities settled using a particular electronic payment system.

How we see it

Entities that adjust their balance sheet at the reporting period end for cash that is in-transit, should prepare to cease this practice. Whilst the clarification that will drive this change is still only proposed in an ED, there is a very low likelihood of it not becoming an IFRS requirement, so entities should plan accordingly.

Entities should review the electronic payment systems they use to understand whether they would apply the proposed accounting policy election and identify when in the payment process the conditions for derecognition would be met. This may require significant work, especially for entities that operate in multiple jurisdictions and with significant cross-border payments.

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[1] Exposure Draft, Amendments to the Classification and Measurement of Financial Instruments, March 2023, paragraph B3.1.2A page 11 LINK.

[2] Ibid, paragraph B3.3.8, page 11 LINK.

[3] E.g., a cheque written to settle a financial liability but not cleared at the reporting date is deducted from the cash balance and the corresponding liability is derecognised.

Assessing the contractual cash flow characteristics for the classification of financial assets

Financial assets with ESG-linked features [4]

The accounting treatment for financial assets with ESG-linked features, such as where the interest rate varies depending on the achievement of ESG goals, was identified as a high priority to be addressed in the PIR. Nevertheless, the IASB decided not to develop guidance specific to ESG-linked financial instruments. This is because to do so would diverge from the principles-based approach of IFRS 9, including the solely payment of principal and interest on the principal amount outstanding (SPPI) assessment.

Instead, the IASB proposes two broad amendments. The first helps identify whether the compensation the lender receives is consistent with a basic lending arrangement by requiring consideration of:

- What the lender is compensated for
- Whether the compensation covers risks or market factors not typically considered consistent with a basic lending arrangement
- If a change in contractual cash flows is inconsistent with a basic lending arrangement, including the direction and magnitude of any change

The second amendment expands the guidance for how contractual terms that change the timing or amount of contractual cash flows over the life of the financial asset should be assessed by considering:

- Whether the contractually specified change would meet the SPPI requirement irrespective of the probability of the contingent event occurring
- To be consistent with a basic lending arrangement, the occurrence or non-occurrence of the contingent event must be specific to the debtor
- The resulting contractual cash flows must represent neither an investment in the debtor nor an exposure to the performance of specified assets

In addition, the ED proposes adding two examples to illustrate this approach.

How we see it

We welcome the IASB's efforts to provide guidance in this area. However, as the effect of the proposals is very broad, entities should assess whether there are any unintended consequences for the classification of financial assets other than those with ESG-linked features.

Financial assets with non-recourse features [5]

IFRS 9 defines a non-recourse financial asset as one where a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets. Non-recourse financial assets that do not meet the SPPI conditions are carried at fair value through profit or loss.

The ED proposes that for a financial asset to have non-recourse features, the entity's contractual right to receive cash flows must be limited to specified assets over the life of the financial asset and in default, i.e., the entity is exposed to the specified asset's performance risk not the debtor's credit risk.

The ED also proposes that in assessing if the SPPI conditions are met, the entity should consider the legal and capital structure of the debtor. This includes the extent to which the cash flows of the underlying assets are expected to exceed the contractual cash flows of the financial asset being classified and whether any cash shortfall will be absorbed by subordinated instruments issued by the debtor.

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[4] Ibid, paragraph B4.1.8A page 12, B4.1.10A page 13, B4.1.14 page 14 LINK.

[5] Ibid, paragraph B4.1.16A and B4.1.17A page 15 LINK.

Contractually linked instruments [6]

Contractually linked instruments (CLI) can arise in structures where issuers create concentrations of credit risk through tranches of debt. To determine whether CLI satisfy the SPPI assessment and can, therefore, be carried at amortised cost, IFRS 9 requires specific criteria to be met. The ED proposes the following amendments:

- Clarifying the characteristics of CLI through specific reference to the concentrations of credit risk resulting in the disproportionate allocation of losses between different tranches
- Where an entity issues multiple debt instruments of different seniority to facilitate lending from a single creditor, this will not create CLI
- The underlying pool can include financial instruments not in the scope of IFRS 9 (e.g., lease receivables), but must have cash flows that meet SPPI

Amendments to IFRS 7 *Financial Instruments: Disclosures* [7]

For investments in equity instruments designated at FVTOCI, the IASB decided the requirement that amounts deferred in OCI are not recycled to profit and loss, was working as intended. However, the ED proposes to add a disclosure requirement for the change in fair value during the period, to show separately amounts relating to investments derecognised in the period and those held at period end. Also, the aggregate fair value of investments at FVTOCI will be disclosed.

For contingent events, the ED proposes new disclosures to allow users to better understand the effects of terms that could change the timing or amount of contractual cash flows. They apply to financial instruments with ESG-linked features discussed above, and to all other financial assets at amortised cost, or FVTOCI and financial liabilities at amortised cost, with contingent features, in particular:

- A qualitative description of the nature of the contingent event
- Quantitative information about the range of changes to contractual cash flows that could result from the contractual terms
- The gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms

How we see it

Obtaining the quantitative and qualitative data needed for the disclosure of financial instruments with contingent features may require significant effort.

Given the broad scope of instruments captured by the disclosure, careful consideration is required to balance the need to provide sufficient details to be useful to users of the accounts with the risk of information overload.

Transition and effective date

The new requirements would be applied retrospectively, with an adjustment to opening retained earnings. Prior periods would not need to be restated.

How we see it

The date of mandatory initial application is to be determined, but given the work still needed to finalise the amendments and to allow time for implementation, it is unlikely to be earlier than for periods beginning on or after 1 January 2025.

Even though many of the proposals are intended by the IASB as clarifications to existing IFRS, given that they require changes to current standards, they should not be applied until the amendments come into effect.

As drafted, the amendments will have to be implemented all at the same time. Therefore, if entities intend to apply certain amendments early, such as those for ESG instruments, they will also have to early adopt all the other amendments.

[6] Ibid, paragraph B4.1.20 page 15 and B4.1.20A, B4.1.21 and B4.1.23 page 16 LINK.
[7] Ibid, paragraph 11A and 20B page 17, 20C and 44JJ, page 18 LINK.

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ED None