IASB PUBLISHES EXPOSURE DRAFT - *AMENDMENTS TO THE CLASSIFICATION AND MEASUREMENT OF FINANCIAL INSTRUMENTS*

INTERNATIONAL FINANCIAL REPORTING BULLETIN

2023/03

April 2023

BACKGROUND

STATUS
Exposure Draft

ACCOUNTING IMPACT
The Exposure Draft proposes amendments to the requirements for settling financial liabilities using an electronic payment system and assessing contractual cash flow characteristics of financial assets, including those with ESG-linked features. It also proposes amendments to some disclosure requirements in IFRS 7.

In 2022, the IASB carried out a post-implementation review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments* and related requirements in IFRS 7 *Financial Instruments: Disclosures*. After analysing the feedback, the IASB concluded that, in general, entities are able to apply the classification and measurement requirements of IFRS 9 consistently; however, clarification is needed on certain matters to improve the understandability of the requirements.

In September 2021, the IFRS Interpretations Committee (the Committee) issued a Tentative Agenda Decision (TAD) that addressed a request received about the recognition of cash received via an electronic transfer system as settlement for a financial asset. Some concerns were raised about the possible implications of the TAD, primarily on settlement of financial liabilities. Acknowledging these concerns, the IASB decided to propose amendments to the requirements in IFRS 9.

On 21 March 2023, the IASB proposed narrow-scope amendments to IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures* that address the above two matters i.e. areas requiring clarification, as identified from the feedback to the PIR, and concerns raised on the TAD on the recognition of cash received via an electronic transfer system as settlement for a financial asset.

The Exposure Draft *Amendments to the Classification and Measurement of Financial Instruments* includes the following proposals:

Proposals	
1	**Derecognition of financial liabilities settled through electronic transfers**
2	**Classification of financial assets**
	Elements of interest in a basic lending arrangement
	Contractual terms that change the timing or amount of contractual cash flows
	Financial assets with non-recourse features
	Investments in contractually linked instruments
3	**Disclosures**
	Investments in equity instruments designated at fair value through other comprehensive income
	Contractual terms that could change the timing or amount of contractual cash flows

Primarily to address financial assets with environmental, social and governance (ESG)-linked features

The Exposure Draft is open for comments until 19 July 2023.

DERECOGNITION OF FINANCIAL LIABILITIES

What is the issue?

In 2021, IFRS Interpretations Committee (the Committee) received a request about the recognition of cash received via an electronic transfer system as settlement for a financial asset.

The fact pattern in the request described an electronic transfer system that has an automated settlement process that takes three working days to settle a cash transfer. All cash transfers made via the system are therefore settled (deposited in the recipient's bank account) two working days after they are initiated by the payer. An entity has a trade receivable with a customer. At the entity's reporting date, the customer has initiated a cash transfer via the electronic transfer system to settle the trade receivable. The entity receives the cash in its bank account two days after its reporting date. The question raised was whether the entity can derecognise the trade receivable and recognise cash on the date the cash transfer is initiated (its reporting date), rather than on the date the cash transfer is settled (after its reporting date).

The Committee concluded in its TAD that, applying IFRS 9, an entity:

- derecognises a trade receivable on the date when its contractual rights to the cash flows from the trade receivable expire; and
- recognises the cash (or other financial asset) received as settlement of that trade receivable on the same date.

Although most respondents to the TAD agreed with or did not disagree with the technical analysis in the TAD, a number of concerns were raised on other implications of the TAD, especially in the context of settlement of financial liabilities such as trade payables.

The main concerns raised included the following:

- Unintended possible consequences for other fact patterns such as accounting for settlement of trade payables and risk of inconsistent application to fact patterns beyond the one considered in the request.
- Disruption to long-standing accounting practices such as performing bank reconciliations and accounting for cheques when written or received.
- Changes in approach as a consequence of the agenda decision being costly and complex to apply due to required changes to systems, processes and internal controls and possible legal analysis required to determine when rights to cash flows expire.

Given these concerns, the IASB decided to propose amendments to the requirements of IFRS 9 before considering whether to finalise the agenda decision.

What is the IASB proposing?

Currently, IFRS 9 does not explicitly specify whether an entity is required to apply trade date accounting or settlement date accounting when recognising or derecognising a financial asset or a financial liability, except for regular way purchase or sale of assets.

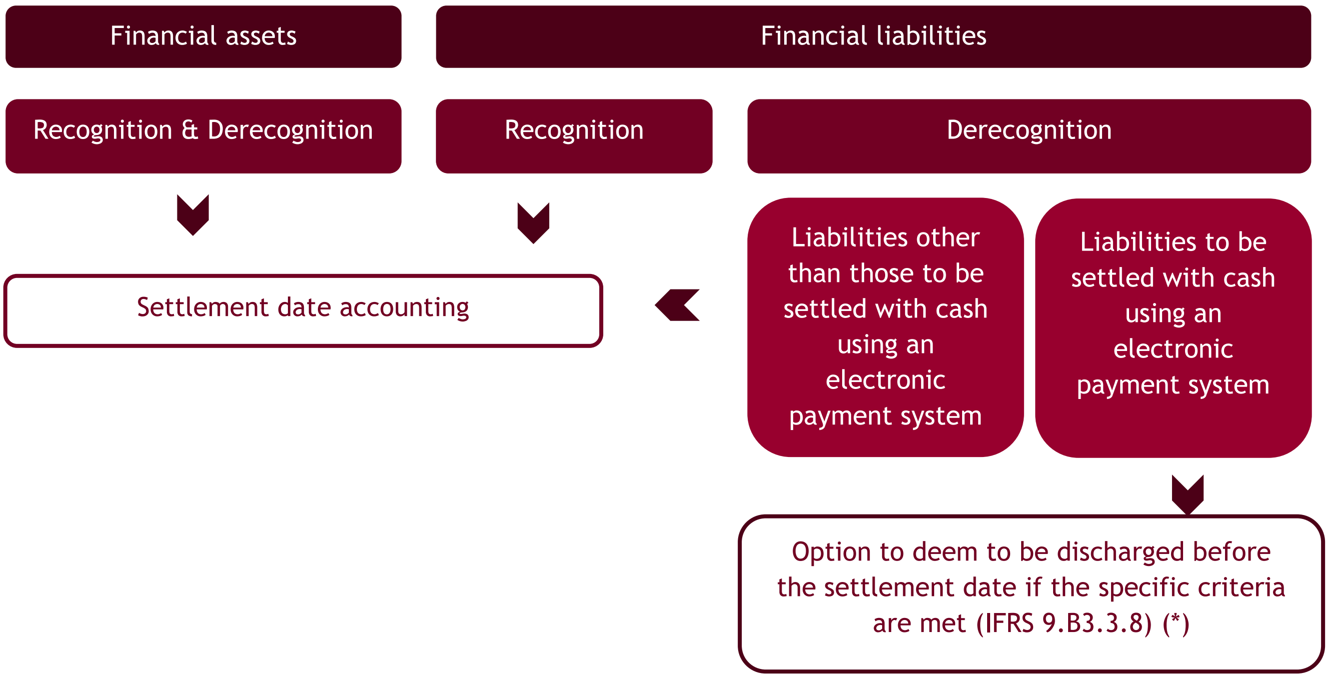
The Exposure Draft now proposes to clarify that entities are required to apply settlement date accounting when recognising or derecognising a financial asset or a financial liability, with the following exceptions:

- An entity may follow trade date or settlement date accounting for regular way purchase or sale of assets. There is no change proposed in the requirements for regular way purchase of sale of assets.

- IFRS 9.B3.3.8, as proposed: An entity is permitted to deem a financial liability, that will be settled with cash using an electronic payment system, to be discharged before the settlement date if, and only if, the entity has initiated the payment instruction and:
  a) the entity has no ability to withdraw, stop or cancel the payment instruction;
  b) the entity has no practical ability to access the cash to be used for settlement as a result of the payment instruction; and
  c) the settlement risk associated with the electronic payment system is insignificant.

The Exposure Draft also provides a clarification on when settlement risk is considered to be insignificant.

The following diagram summarises the proposed requirements related to trade or settlement date accounting (except for regular way sale or purchase of assets, for which there is no change proposed) for recognition and derecognition of financial assets or financial labilities:



(*) to be applied to all settlements made through the same electronic payment system.

Why is the proposed amendment restricted to liabilities to be settled with cash using an electronic payment system?

As explained in the Basis for Conclusions to the Exposure Draft, applying the proposed requirements to a wider population of cash payments (for example, cash payments from demand deposits) would give rise to conceptual and practical challenges.

There is a risk that cash would be seen as being treated differently from other financial assets for the purposes of the derecognition requirements in IFRS 9. This could lead to different accounting outcomes when an entity settles a transaction with cash rather than by delivering another financial asset, such as a security.

Considering these challenges, the IASB decided to limit the scope of the proposed requirements to cash settlements using electronic payment systems that meet the specified criteria.

Implications of the proposed amendment

- Entities may need to change their existing accounting practices for derecognition of financial assets such as trade receivable and recognition of cash received via modes of payments such as electronic transfers or cheques.
- Entities may also need to change their existing accounting practices for derecognition of financial liabilities such as trade payables and derecognition of cash paid via modes of payment such as cheques or electronic transfers that do not meet the specified criteria.

CLASSIFICATION OF FINANCIAL ASSETS – ESG LINKED FEATURES

Background

Appendix B to IFRS 9 includes application guidance on assessing whether a financial asset's contractual cash flows are solely payments of principal and interest (SPPI) on the principal amount outstanding. This assessment is important because if the instrument does not meet this 'SPPI test', then the instrument must be measured at fair value through profit or loss by the holder. Respondents to the PIR observed that it is challenging to apply the SPPI requirements to financial assets with ESG-linked or similar features.

The IASB considered this feedback but decided against creating an exception for assets with ESG-linked features. Instead, the IASB has proposed to clarify the general SPPI principles by clarifying the requirements applicable to:

- Elements of interest in a basic lending arrangement; and
- Contractual terms that change the timing or amount of contractual cash flows.

Elements of interest in a basic lending arrangement

What is the issue?

IFRS 9.B4.1.7A states that (emphasis added):

> *'Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement,* ***consideration for the time value of money and credit risk*** *are typically the* ***most significant elements of interest****. However, in such an arrangement, interest can also include consideration for* ***other basic lending risks*** *(for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include* ***a profit margin*** *that is consistent with a basic lending arrangement…'*

Applying these requirements to financial assets with ESG-linked features can be challenging. Consider the following example.

Entity A purchases green bonds of Entity B. The bonds carry a coupon of 4% per annum. If Entity B fails to meet its target of reduction in greenhouse gas emissions in a reporting period, the coupon is increased to 5% per annum. In this case, it is challenging to determine whether the changing interest rate is consistent with a basic lending arrangement i.e. whether the incremental interest of 1% is consideration for elements of interest in a basic lending arrangement such as for time value of money, credit risk, liquidity risk, etc. or for some other factor.

What is the IASB proposing?

In order to assist entities assess whether the interest in an arrangement is consistent with a basic lending arrangement, the Exposure Draft proposes to clarify that:

- *The assessment of interest focuses on what an entity is being compensated for, rather than how much compensation an entity receives.*

  The Basis for Conclusion to IFRS 9 (BC4.182(b)) currently notes that the assessment of interest focuses on *what* the entity is being compensated for (i.e. whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of *how much* the entity receives for a particular element. For example, different entities may price the credit risk element differently.

  The IASB decided to incorporate this principle into the application guidance.

- *Contractual cash flows are inconsistent with a basic lending arrangement if they include compensation for risks or market factors that are not typically considered to be basic lending risks or costs (for example, a share of the debtor's revenue or profit), even if such contractual terms are common in the market in which the entity operates.*

  The IASB notes in the Basis for Conclusions to the Exposure Draft that just because something is common practice in a particular jurisdiction, it does not necessarily result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

- *A change in contractual cash flows is inconsistent with a basic lending arrangement if it is not aligned with the direction and magnitude of the change in basic lending risks or costs.*

  In a basic lending relationship, there is a relationship between the perceived risk the lender is taking on and the compensation it receives for that risk. For contractual cash flows to be consistent with a basic lending arrangement, a change in contractual cash flows has to be directionally consistent with and proportionate to, a change in lending risks or costs. For example, if the rate of interest decreases when the credit risk of the borrower has increased, the change in contractual cash flows is inconsistent with a basic lending arrangement.

Contractual terms that change the timing or amount of contractual cash flows

Sometimes a financial asset contains a contractual term that could change the timing or amount of contractual cash flows. For example, the asset can be prepaid before maturity. In such cases, IFRS 9.B4.1.10 requires the entity to determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows.

The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. For example, consider a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments. The contractual cash flows for this instrument are more likely to be SPPI than for a financial instrument with an interest rate that reset based on equity index level.

What is the issue?

The feedback to the PIR suggested that, from the example in IFRS 9.B4.1.10, entities might infer that, for cash flows to be SPPI, the nature of any contingent event must be associated with one of the elements of interest specified in IFRS 9.B4.1.7A.

As noted by the IASB in the Basis for Conclusions to the Exposure Draft, variability cannot be assumed to be consistent with a basic lending arrangement simply because it arises from one of the elements of interest mentioned in IFRS 9.B4.1.7A. Furthermore, the variability in cash flows need not relate to one of the elements of interest explicitly mentioned in IFRS 9.B4.1.7A.

What is the IASB proposing?

In order to clarify the principles for assessing the contractual cash flows over the life of a financial asset, the Exposure Draft proposes to clarify that:

- *whether the contractually specified change would meet the SPPI requirement shall be assessed irrespective of the probability of the contingent event occurring (except for non-genuine contractual terms as described in IFRS 9.B4.1.18).*

  The contractual cash flow assessment is based on on all contractual cash flows that could arise over the life of the financial instrument. It is not a probability-based assessment.

- *for a change in contractual cash flows to be consistent with a basic lending arrangement, the occurrence (or non-occurrence) of the contingent event must be specific to the debtor.*

  Changes in contractual cash flows arising from contingent events that are not specific to a debtor or depend on factors that are unrelated to the debtor would not be consistent with a basic lending arrangement. For example, a reduction in interest rates based on reduction in industry-wide greenhouse gas emissions would not be consistent with a basic lending arrangement.

  It should be noted that not all contingent events that are specific to a debtor would be consistent with a basic lending arrangement. For example, a reduction in interest rate on a specified increase in debtor's revenue would not generally be considered to be consistent with a basic lending arrangement.

- *the resulting contractual cash flows must represent neither an investment in the debtor nor an exposure to the performance of specified assets.*

  The nature of a contingent event could be an indicator that a financial asset's contractual cash flows represent an investment in the debtor or exposure to the performance of specified assets.

The Exposure Draft includes the following two examples to illustrate the application of the proposed amendments:

Instrument	Analysis
The instrument is a loan with an interest rate that is periodically adjusted by a specified number of basis points if the debtor achieves a contractually specified reduction in greenhouse gas emissions during the preceding reporting period.	The occurrence of the contingent event i.e. achieving a contractually specified reduction in greenhouse gas emissions is specific to the debtor. The contractual cash flows arising from the occurrence (or nonoccurrence) of the contingent event are in all circumstances solely payments of principal and interest on the principal amount outstanding.
The instrument is a loan with an interest rate that is periodically adjusted when a market-determined carbon price index reaches a contractually defined threshold.	The contractual cash flows change in response to a market factor (the carbon price index), which is not a basic lending risk or cost and is therefore inconsistent with a basic lending arrangement.

CLASSIFICATION OF FINANCIAL ASSETS – FINANCIAL ASSETS WITH NON-RECOURSE FEATURES

How do non-recourse features affect the classification of financial assets?

A non-recourse feature is where the lender's claim is limited to specified assets (or cash flows from specified assets) of the borrower. The borrower has no further obligation beyond the asset that has been pledged.

For example, a bank provides a loan to Entity A for purchase of an investment property. The loan is secured by first charge over the property. If Entity A fails to repay the loan, the bank has the right to possess the property. However, the bank does not have recourse to other assets of Entity A. For instance, if the market value of the property of the date of possession by the bank is CU8 million and the loan outstanding is CU10 million, the bank does not have a recourse to other assets of Entity A to cover the shortfall of CU2 million.

Non-recourse features may indicate an investment in particular assets or cash flows and therefore, the contractual cash flows may not meet the SPPI test.

The existence of a non-recourse provision does not in itself preclude a financial asset from meeting the SPPI test. IFRS 9.B4.1.17 requires the creditor to 'look through to' the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are SPPI.

What is the issue?

PIR participants asked the IASB to clarify the difference between financial assets with non-recourse features and financial assets for which a creditor's claim is secured by the assets pledged as collateral.

As explained in the Basis for Conclusions to the Exposure Draft, in the case of a collateralised loan, a creditor's claim is secured by the collateral only in the case of default. Throughout the life of such a loan, the creditor has recourse to the debtor for repayment of the loan. In case of financial assets with non-recourse features, the creditor's claim is limited to the specified underlying assets throughout the life of the financial assets as well as in the case of default.

		Financial assets with non-recourse features	Collateralised loan
Recourse to the debtor	Throughout the life of the loan	No recourse	Recourse available
	On default	No recourse	No recourse

What is the IASB proposing?

The Exposure Draft proposes to include the following clarification with respect to non-recourse features (emphasis added):

> *….A financial asset has non-recourse features if an entity's contractual right to receive cash flows is limited to the cash flows generated by specified assets* ***both over the life of the financial asset and in the case of default****. In other words, throughout the life of the financial asset, the entity is primarily exposed to the specified assets' performance risk rather than the debtor's credit risk.*

To assist entities in the assessment of 'looking through to' the particular underlying assets or cash flows, the Exposure Draft further proposes to clarify that an entity may also need to consider factors such as the legal and capital structure of the debtor, including, but not limited to, the extent to which:

a) the cash flows generated by the underlying assets are expected to exceed the contractual cash flows on the financial asset being classified; and

b) any shortfall in cash flows generated by the underlying assets is expected to be absorbed by subordinated debt or equity instruments issued by the debtor.

CLASSIFICATION OF FINANCIAL ASSETS – INVESTMENTS IN CONTRACTUALLY LINKED INSTRUMENTS

What is the issue involved?

In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments, known as tranches. In assessing whether investments in such instruments meet the SPPI requirement, IFRS 9 requires an entity to 'look through' until it can identify the underlying pool of financial instruments that are creating, instead of passing through the cash flows. The entity is then required to assess, among other things, whether this underlying pool contains one or more instruments that have SPPI cash flows.

PIR participants asked the IASB to clarify the scope of the requirements in IFRS 9 related to contractually linked instruments to identify the instruments to which these requirements apply. Participants also asked whether financial instruments that are not entirely within the scope of IFRS 9 could meet the criteria for financial instruments in the underlying pool, as required by IFRS 9.B4.1.23.

What is the IASB proposing?

Scope:

The Exposure Draft proposes to include the following clarifications on the characteristics of contractually linked instruments:

- the prioritisation of payments to the holders of these tranches is established through a waterfall payment structure;
- that payment structure creates concentrations of credit risk and results in a disproportionate allocation of losses between the holders of different tranches;
- the tranches have non-recourse features.

Bilateral secured lending arrangements:
A bilateral secured lending arrangement involves the creation of a structured entity that issues multiple debt instruments (i.e. senior and junior) to facilitate a lending transaction with a single creditor (the entity). The senior debt instrument is issued to the creditor and the junior debt instrument is issued to the debtor, which provides credit protection to the senior debt instrument holder.

For example, Entity A has a pool of car loans amounting to CU100 million. In order to obtain funding against the pool of car loans, Entity A agrees to enter into a secured lending arrangement with Entity B. Under the arrangement, Entity A transfers the assets of CU100 million to a Special Purpose Entity (SPE). The SPE issues senior debt instruments of CU80 million to Entity B and junior debt instruments of CU20 million to Entity A.

The IASB proposes to clarify that such bilateral secured lending arrangements do not contain contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single creditor. The contractual cash flows of the senior debt instrument in such transactions shall be assessed by applying the requirements in IFRS 9.B4.1.7-B4.1.19.

Composition of the underlying pool of financial instruments:

In response to the feedback from the PIR, the IASB proposes to clarify that financial instruments that are not within the scope of the classification requirements of IFRS 9, such as lease receivables, can be included in the underlying pool of financial instruments provided they have cash flows that are equivalent to SPPI cash flows.

DISCLOSURES

Investments in equity instruments designated at fair value through other comprehensive income (OCI)

When an equity investment designated at fair value through OCI is disposed of, IFRS 9 prohibits the entity from reclassifying the amounts accumulated in OCI to profit or loss. Some PIR participants noted that this treatment may not faithfully represent the performance of such investments upon disposal.

The IASB noted that neither IFRS 9 nor IFRS 7 distinguishes between ‘realised’ and ‘unrealised’ gains or losses, and that it had received no evidence as part of the PIR to support the contention that reclassification of amounts recognised and accumulated in OCI to profit or loss would necessarily result in users of financial statements receiving more or better information about realised gains than they do from existing requirements.

However, in response to the feedback, the IASB is proposing to require entities to disclose the amount of change in the fair value of investments in equity instruments designated at fair value through OCI during the period, showing separately the amount of that change related to investments derecognised during the reporting period and the amount of that change related to investments held at the end of the reporting period.

Contractual terms that could change the timing or amount of contractual cash flows

PIR participants noted that understanding the effect of contractual terms that could change the timing or amount of contractual cash flows is important to their analysis and assessment of an entity's future cash flows. IFRS 7 currently does not specifically require an entity to disclose the effect of contractual terms that could change the timing or amount of the contractual cash flows of these financial instruments.

The IASB is therefore proposing to include the following disclosure requirement related to the effect of contractual terms that could change the timing or amount of contractual cash flows based on the occurrence (or non-occurrence) of a contingent event that is specific to the debtor:

a) a qualitative description of the nature of the contingent event;

b) quantitative information about the range of changes to contractual cash flows that could result from those contractual terms; and

c) the gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms.

TRANSITION

The Exposure Draft proposes that the amendments shall be applied retrospectively, in accordance with the requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The Exposure Draft proposes the following with respect to restatement of prior periods:

- An entity is not required to restate prior periods to reflect the application of these amendments.
- An entity may restate prior periods if, and only if, it is possible to do so without the use of hindsight.
- If an entity does not restate prior periods, any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments shall be recognised in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

The effective date of the amendments will be considered by the IASB when they deliberate on the feedback received to the exposure draft.

www.bdo.global