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Need to know
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Need to know

IASB proposes amendments to the classification and measurement requirements of financial instruments

Contents

Background

The proposed amendments

Effective date, transition and comment period

Further information

This *Need to know* outlines the proposed amendments to IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures* set out in Exposure Draft (ED) IASB/ED/2023/2 *Amendments to the Classification and Measurement of Financial Instruments—Proposed amendments to IFRS 9 and IFRS 7,* published by the International Accounting Standards Board (IASB) in March 2023.

- The IASB proposes amendments to IFRS 9 to address:
  - Derecognition of a financial liability settled through electronic transfer
  - Classification of financial assets—contractual terms that are consistent with a basic lending arrangement
  - Classification of financial assets—financial assets with non-recourse features
  - Classification of financial assets—contractually linked instruments
- The following amendments to IFRS 7 are proposed:
  - Disclosures—investments in equity instruments designated at fair value through other comprehensive income
  - Disclosures—contractual terms that could change the timing or amount of contractual cash flows on the occurrence (or non-occurrence) of a contingent event
- The need for these amendments was identified as a result of the IASB's post-implementation review of the classification and measurement requirements of IFRS 9
- The ED does not specify an effective date for the amendments. Entities would be required to apply the amendments retrospectively. Restatement of comparative information would not be required but would be permitted if it is possible to do so without hindsight. Information about financial assets that change measurement category because of the amendments would be required to be disclosed
- The comment period for the ED ends on 19 July 2023

For more information please see the following websites:

www.ukaccountingplus.co.uk

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Background

In 2022, the IASB concluded its post-implementation review (PIR) of the classification and measurement requirements of IFRS 9. In general, the IASB found that preparers can apply the requirements consistently. However, the IASB identified some matters that require amendments to IFRS 9 and IFRS 7. The IASB decided to propose these amendments in a single ED.

The proposed amendments

Derecognition of a financial liability settled through electronic transfer

The ED proposes that settlement date accounting is required when recognising or derecognising a financial asset or a financial liability unless the 'regular way exception' in IFRS 9: 3.1.2 applies. In addition, instead of using settlement date accounting an entity would be permitted to derecognise a financial liability settled using an electronic payment system if all the following conditions are met:

- The entity has initiated the payment instruction
- 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

The IASB proposes to clarify that settlement risk is insignificant if the characteristics of the electronic payment system are such that completion of the payment instruction follows a standard administrative process and the time between initiating a payment instruction and the cash being delivered is short.

Settlement risk would not be insignificant if the completion of the payment instruction is subject to the entity's ability to deliver cash on the settlement date.

An entity that elects to apply the proposed derecognition alternative for financial liabilities would be required to apply it to all settlements made through the same electronic payment system.

Observation

The application of IFRS 9 to the derecognition of a financial asset settled via an electronic transfer was brought to the attention of the IFRS Interpretation Committee in September 2021. At the time, the Committee tentatively concluded that an entity is required (a) to derecognise a trade receivable on the date on which its contractual rights to the cash flows from the trade receivable expire; and (b) to recognise the cash (or other financial asset) received as settlement of that trade receivable on the same date.

The agenda decision was not finalised because of concerns raised about the potential outcomes of the tentative conclusion. Instead, these concerns were referred to the IASB.

In response, the IASB considered amending IFRS 9 to clarify when the contractual rights to the cash flows from a financial asset expire or when a financial liability is extinguished. However, stakeholders of the IASB noted that determining exactly when a liability is extinguished, or the rights to the cash flows from a financial asset expire, could be time-consuming, costly and involve extensive (legal) analysis of each payment platform and the related individual contractual terms. This is because the relevant regulations and requirements to determine the point of extinguishment vary between jurisdictions and could potentially lead to economically similar financial assets and financial liabilities being derecognised at different times.

The IASB therefore decided not to fundamentally reconsider the recognition and derecognition requirements in IFRS 9 and to propose the narrow-scope amendments set out above instead.

Classification of financial assets

Contractual terms that are consistent with a basic lending arrangement

The ED proposes amendments to the application guidance of IFRS 9 to provide guidance on how an entity assesses whether contractual cash flows of a financial asset are consistent with a basic lending arrangement. This is intended to assist an entity to apply the requirements for assessing contractual cash flow characteristics to financial assets with features linked to environmental, social and governance (ESG) concerns.

The IASB proposes to specify that when assessing interest, an entity would focus on *what* an entity is being compensated for, rather than *how much* compensation it receives. Under the proposals, contractual cash flows would be 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). This is proposed to be the case even if such contractual terms are common in the market in which the entity operates.

Furthermore, 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.

Contractual terms that could change the timing or amount of contractual cash flows following the occurrence (or non-occurrence) of any contingent event would be consistent with a basic lending arrangement if the contingent event is specific to the debtor. This would be the case if the occurrence of the contingent event depends on the debtor achieving a contractually specified target, even if the same target is included in other contracts for other debtors. However, the resulting contractual cash flows must represent neither an investment in the debtor nor an exposure to the performance of specified assets.

In order to illustrate the above the IASB proposes adding the following two examples of financial assets that have, or do not have, contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Example 1:
Instrument EA 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 (achieving a contractually specified reduction in greenhouse gas emissions) is specific to the debtor and the contractual cash flows arising from the occurrence (or non-occurrence) of the contingent event are in all circumstances solely payments of principal and interest on the principal amount outstanding. The contractual cash flow do not represent an investment in the debtor nor an exposure to the performance of specified assets. Therefore, this would be consistent with a basic lending arrangement.

Example 2:
Instrument I 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.

Observation
The IASB found that the contractual cash flow characteristics assessment in IFRS 9 is as relevant to financial assets with ESG-linked features as it is to other financial assets, and that the requirements in IFRS 9 (subject to the above proposed clarifications) provide an appropriate basis to determine whether such financial assets meet the conditions to be measured at amortised cost or FVTOCI.

The IASB therefore concluded that creating an exception from the requirements on contractual cash flow characteristics in IFRS 9 for financial assets with ESG-linked features would not be appropriate.

Financial assets with non-recourse features
Amendments to IFRS 9 are proposed to enhance the description of the term 'non-recourse'. Under the amendments, 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.

The IASB proposes to explain that as part of its assessment of the contractual cash flow characteristics of financial assets with non-recourse features, an entity may need to consider factors such as the legal and capital structure of the debtor, including, but not limited to, the extent to which:
- The cash flows generated by the underlying assets are expected to exceed the contractual cash flows on the financial asset being classified
- 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

Contractually linked instruments
The IASB proposes to clarify the characteristics of contractually linked instruments that distinguish them from other transactions. Specifically, the IASB proposes to add that 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 proposed amendments would also note that not all transactions with multiple debt instruments meet the criteria of transactions with multiple contractually linked instruments. For example, a creditor may enter into a secured lending arrangement whereby the debtor (the sponsoring entity) establishes a structured entity to hold the security which issues senior and junior debt instruments. The debtor holds the junior debt instrument to provide credit protection to the entity holding the senior debt instrument. Under the proposed amendments, such transactions do not contain multiple contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single creditor.

In addition, the proposed amendments clarify that the reference to instruments in the underlying pool can include financial instruments that are not within the scope of the classification requirements. For example, lease receivables that have contractual cash flows that are equivalent to payments of principal and interest on the principal outstanding.

Disclosures

Investments in equity instruments designated at fair value through other comprehensive income (FVTOCI)
The ED proposes amendments to the disclosures an entity provides in respect of investments in equity instruments designated at FVTOCI. In particular, an entity would be required to disclose the changes in fair value during the period, showing separately the amount of the change that relates to investments derecognised in the period and the amount that relates to investments held at the end of the period.

Contractual terms that could change the timing or amount of contractual cash flows
The IASB proposes disclosure requirements for financial instruments that include contractual terms that could change the timing or amount of contractual cash flows on the occurrence (or non-occurrence) of a contingent event that is specific to the debtor. The proposed requirements would apply to each class of financial asset measured at amortised cost or FVTOCI and to each class of financial liability measured at amortised cost.

Effective date, transition and comment period

The ED does not specify an effective date for the amendments in the ED. The effective date will be set at a later point.

The IASB proposes to require an entity to apply the amendments to IFRS 9 retrospectively. An entity would not be required, to restate comparative information or to provide the disclosures required by the amendments to IFRS 7 for any period presented beginning before the date of initial application of the amendments. In respect of the amendments to IFRS 9, an entity would be permitted to restate the prior periods if, and only if, it is possible to do so without the use of hindsight.

An entity would be required to disclose information about financial assets that changed measurement category as a result of applying the amendments to IFRS 9.

The comment period for the ED ends on 19 July 2023.

Further information

If you have any questions about the proposed amendments to IFRS 9 and IFRS 7, please speak to your usual Deloitte contact.

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