EFRAG Secretariat: Laura Abeni, Galina Borisova, Sapna Heeralall

IASB ED/2023/2 *Amendments to the Classification and Measurement of Financial* Instruments *(Proposed amendments to IFRS 9 and IFRS 7)* Cover Note

Objective

1 The objectives of the session are to:

(a) consider the feedback received in response to EFRAG's draft comment letter ('DCL') on the exposure draft ED/2023/2 *Amendments to the Classification and Measurement of Financial Instruments (Proposed amendments to IFRS 9 and IFRS 7)*, issued by the IASB on 21 March 2023 (the 'ED'); and

(b) discuss and recommend to the EFRAG FRB a final comment letter on the ED.

Background of the IASB project

2 The IASB carried out a post-implementation review of the classification and measurement requirements in IFRS 9 *Financial Instruments* and related requirements in IFRS 7 *Financial Instruments: Disclosures*, in accordance with the IASB's due process. The work completed by the IASB and the conclusions it reached are summarised in the Project Report and Feedback Statement—Post-implementation Review of IFRS 9 Financial Instruments—Classification and Measurement, published in December 2022.

3 In analysing the feedback, the IASB decided to propose narrow-scope amendments to IFRS 9 and IFRS 7 to address some of the findings from the post-implementation review.

4 The IASB's ED was published on 21 March 2023 with comments requested by 19 July 2023.

5 The ED proposes amendments to the following requirements:

(a) settling financial liabilities using an electronic payment system; and

(b) assessing contractual cash flow characteristics of financial assets, including those with environmental, social and governance (ESG)-linked features.

6 The ED also proposes amendments or additions to the disclosure requirements for:

(a) investments in equity instruments designated at fair value through other comprehensive income; and

(b) financial instruments with contractual terms that could change the timing or amount of contractual cash flows based on the occurrence (or non-occurrence) of a contingent event.

7 A summary of the IASB proposals can be found here.

8 The questions to EFRAG FR TEG members are included in agenda paper 01-02, and in paragraph 45 of this cover note.

EFRAG's initial position on the ED

9 EFRAG published its DCL on 5 May 2023, with a comment deadline till 30 June 2023.

10 EFRAG welcomed the IASB's efforts to address the concerns of stakeholders raised in the context of the Post-implementation Review of IFRS 9 Classification and Measurement (the 'PIR') and a request to the IFRS Interpretations Committee (the 'IFRS IC'). This ED mainly responds to a request from stakeholders to clarify some aspects of the application guidance for assessing the contractual cash flow characteristics of financial assets and accounting for the settlement of a financial liability using an electronic payment system.

11 In general, EFRAG welcomed the IASB's ED and agreed with the proposed amendments to the classification and measurement of financial instruments.

12 EFRAG considered that the proposed clarifications to the solely payments of principal and interest ('SPPI') requirements would provide a good basis for evaluating whether contractual cash flows of financial assets with ESG-linked or similar features meet SPPI requirements. Considering the rapid increase in financial assets with ESG-linked features in Europe, EFRAG would like to remind that this solution is expeditiously needed. Therefore, EFRAG encouraged the IASB to prioritise the publication of the proposed clarifications to the general SPPI requirements over the other IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 amendments, allowing entities to apply them as soon as possible.

Derecognition of a financial liability settled through electronic transfer

13 EFRAG welcomed the IASB's decision to address stakeholder concerns through standard-setting, which would allow for proper discussion and establish the appropriate transition requirements.

14 EFRAG considered that the narrow-scope standard-setting approach, as proposed in the ED, while not solving all the concerns, would provide a timely and workable solution and reduce costs for the entities concerned.

15 EFRAG, however, suggested (a) amending paragraph B3.1.6 of the ED to include how an entity should apply settlement date accounting to financial liabilities and (b) adding a requirement to disclose the policy used by an entity to recognise and derecognise cash.

Classification of financial assets — contractual terms that are consistent with a basic lending arrangement

16 EFRAG supported the holistic approach chosen by the IASB not to provide a specific exception from the requirements on contractual cash flow characteristics in IFRS 9 for financial assets with ESG-linked features. EFRAG considered that such an approach is principle-based and would provide more flexibility in the future if new instruments with similar types of features would emerge.

17 Nevertheless, to avoid unintended consequences, EFRAG suggested to carefully consider the impact of the proposed requirements about "magnitude" and "contingent event specific to the debtor" on existing financial instruments currently meeting SPPI requirements.

18 EFRAG suggested that the IASB provides a definition and examples of what constitutes a "contingent event", and to clarify that the "de minimis" guidance remains applicable when applying SPPI requirements. EFRAG also suggested providing additional examples to better illustrate the concepts underlying the ED and examples of more complex financial instruments to address the potential application questions.

Classification of financial assets — financial assets with non-recourse features

19 EFRAG supported the IASB decision to clarify that 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. Furthermore, EFRAG supported the IASB's decision to provide examples of the factors that an entity may need to consider when assessing the contractual cash flow characteristics of financial assets with non-recourse features.

20 However, EFRAG noted that the IASB is introducing a new concept into IFRS 9 and the definition of financial assets with non-recourse features provided in the ED is more restrictive than the application of "non-recourse" by current practice.

21 Paragraph B4.1.16 of IFRS 9 refers to a "non-recourse" financial asset as a case when a creditor's claim is limited to specified assets of the debtor (e.g., in the case of default) **or** the cash flows from specified assets (e.g., over the life of the financial asset). Instead, paragraph B4.1.16A of the ED states that a financial asset with non-recourse features has limited cash flows **both** over the life of the financial asset and in the case of default.

Classification of financial assets — contractually linked instruments

22 EFRAG noted that the proposed amendments help to clarify the scope of transactions to which the contractually linked instruments ('CLI') requirement apply and the distinction between CLI transactions and financial assets with non-recourse features.

23 Regarding bilateral secured lending arrangements, as described in paragraph B4.1.20A of the ED, EFRAG welcomed the proposed clarifications that such transactions do not contain multiple contractually linked instruments.

24 In addition, EFRAG welcomed the clarification in paragraph B4.1.23 of IFRS 9 that the reference to instruments in the underlying pool can include financial instruments that are not within the scope of the classification requirements of IFRS 9.

Disclosures

25 Regarding the proposed disclosures relating to investments in equity instruments designated at fair value through other comprehensive income ('FVOCI'), EFRAG noted that its Comment Letter in response to the PIR, mentioned that seventy percent (70%) of respondents from its public consultation considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments.

26 Therefore, even though not the ideal solution, EFRAG, at this stage, agreed with the proposed disclosures. EFRAG will be monitoring the IFRS 9 and IFRS 17 *Insurance Contracts* implementation by the insurance industry to assess the impact resulting from non-recycling of equity instruments measured at FVOCI.

27 Furthermore, EFRAG considered that the disclosure requirements on contractual terms that could change the timing or amount of contractual cash flows would not provide relevant information for credit-impaired financial assets and for financial assets measured at FVOCI. EFRAG noted that the proposed disclosure requirements may result in significant operational challenges by preparers, and therefore, in increased implementation and ongoing costs. EFRAG also suggested that the IASB considers the requirements on quantitative disclosures in the context of the forthcoming IASB project on *Amortised Cost and Effective Interest Rate* applying a more holistic approach. Therefore, on balance, EFRAG agreed with the proposed disclosure requirements.

EFRAG User Panel and IAWG discussions

28 The EFRAG Secretariat collected views on the EFRAG's DCL during EFRAG User Panel and IAWG meetings held on 10 May 2023 (joint meeting with EFRAG FR TEG) and 21 June 2023, respectively.

EFRAG User Panel (joint meeting with EFRAG FR TEG)

29 Members agreed that proposed disclosure on equity instruments designated at FVOCI will provide useful information, especially on disposal of such instruments, given the lack of transparency of OCI amounts.

30 EFRAG FR TEG noted that the proposed disclosures of contractual terms that could change the timing or amount of contractual cash flows represented significant change compared to current IFRS 9 requirements. It was highlighted that the proposed disclosures would cover not only financial instruments with ESG features, but a very large population of financial instruments (for example, mortgages with a repayment option or loans with covenants) for which currently no disclosures were required, and no additional information needs were expressed by users.

31 EFRAG FR TEG further noted that a review of most financial instruments will be necessary to produce such disclosures and asked for more guidance on how to produce quantitative disclosures, for example whether different scenarios and probabilities should be considered to establish the range of changes in contractual cash flows.

32 Some members questioned the need and usefulness of the quantitative disclosures proposed, especially for financial assets measured at FVOCI and financial liabilities measured at amortised cost.

33 Members questioned whether this project was a right place to deal with such disclosures and whether they would not be better considered within either DRM project or in conjunction with future project on amortised cost measurement and effective interest rate.

34 EFRAG UP members considered the proposed disclosures useful as they would provide additional transparency, particularly on financial instruments with ESG features. It could also contribute avoiding greenwashing.

35 One EFRAG FR TEG member questioned how this disclosure would interact with the amounts recognised in the statement of profit or loss as consequence of the IFRS 9 requirements on modifications.

EFRAG IAWG

36 Members welcomed the IASB amendments on contractual terms that are consistent with a basic lending arrangement. Nevertheless, they agreed with the EFRAG DCL on the need for clarity and further examples on the proposed requirements about "magnitude" and "contingent event specific to the debtor". The current wording in the ED appears difficult to apply.

37 In addition, EFRAG IAWG particularly welcomed the proposal in the ED to amend paragraph 11A(c) of IFRS 7 to require disclosure of an aggregate fair value of equity instruments rather than the fair value of each instrument at the end of the reporting period. Members recalled the industry's request to review the non-recycling treatment and pointed out that the proposed disclosure would not have been necessary if the non-recycling treatment were reviewed. One member agreed with the commend made in paragraph 169 of the EFRAG DCL.

38 Members further noted that, on initial analysis, the application of paragraphs 20B and 20C of the ED is complex and the related disclosures are not relevant because the range of changes to contractual cash flows at aggregate level is too broad.

39 EFRAG IAWG suggested amending the EFRAG response to question 6 (and consequently the wording in the cover letter) to better reflect the concerns highlighted by constituents and the strong need of clarity on the scope, the application, and the level of aggregation of the proposed disclosures.

EFRAG FIWG and IAWG discussions on financial instruments with non-financial components

40 During the EFRAG FIWG and IAWG meetings held on 26 May 2023 and 21 June 2023 respectively, the EFRAG Secretariat considered it useful to stimulate a discussion on possible alternatives to accounting for non-financial components in financial instruments.

41 The EFRAG Secretariat introduced the following key elements into the discussion:

(a) in the view of the EFRAG Secretariat, paragraph AG23 of IAS 32 “contradicts” the principle of separation stated in other IFRS Standards;

(b) the EFRAG Secretariat is also of the view that the requirements in paragraph AG23 of IAS 32 “contradict” the requirements in paragraph B5.1.15 of IFRS 9;

(c) IFRS 9 only contains guidance on measuring financial assets and financial liabilities and not financial instruments (as a whole);

(d) On the accounting for the components of a combined contract that are not a financial asset or financial liability, the EFRAG Secretariat considers the following two different approaches possible:

  (i) the first (the “view 1”) would be that all assets and liabilities within the scope of IFRS 9 are treated as if they were net financial assets or net financial liabilities.

  (ii) the second (the “view 2”) would be to consider that the accounting for non-financial assets and non-financial liabilities is not currently regulated in IFRS 9. Therefore, each entity should develop an accounting policy in accordance with the requirements in paragraph 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(e) View 1 may be considered implicit in the action taken by the IASB in issuing the ED with proposed amendments to IFRS 9 and IFRS 7, while view 2 implicitly states that the clarifications proposed to the general SPPI principles in the ED are to a large extent not needed.

(f) Considering view 2, an entity should identify, understand and assign the cash flows that relate to the non-financial components of a combined contract. Accordingly, this exercise will also identify, understand and assign the cash flows that relate to the financial assets or financial liabilities in the same combined contract.

42 Both EFRAG FIWG and IAWG expressed they preference for the IASB proposals in the IASB ED and noted that the alternatives proposed by the EFRAG Secretariat would delay the solution proposed in the ED and might have unintended consequences on accounting for a broader range of financial instruments. Therefore, members recommended not to pursue the proposed alternative.

Comment letters received and EFRAG Secretariat recommendations

43 At the time of writing, EFRAG received comment letters from 8 respondents (and three drafts) representing preparer organisations, national standard-setters, one user organisation, one preparer and one professional membership organisation.

44 Agenda paper 01-02 reports the summary and analysis of the comment letters received and the EFRAG Secretariat's recommendations on EFRAG's proposed final position.

Questions for EFRAG FR TEG

45 Do EFRAG FR TEG agree to recommend to the EFRAG FRB for issuance EFRAG's final comment letter as drafted in agenda paper 01-03 (clean version) and agenda paper 01-04 (marked-up version) [subject to changes agreed in this meeting]?

Next steps

46 EFRAG FRB to approve the EFRAG's final comment letter at its meeting on 18 July 2023.

Agenda Papers

47 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 01-02 – Comment letter analysis;

(b) Agenda paper 01-03 – Proposed final comment letter (clean version); and

(c) Agenda paper 01-04 – Proposed final comment letter (marked-up version).