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Amendments to the Classification and Measurement of Financial Instruments – Derecognition of financial liabilities through electronic transfer

Objective

1 The objective of this paper is to provide the EFRAG FR TEG with a summary of the IASB staff feedback analysis and recommendations on the proposed requirements regarding the derecognition of a financial liability through electronic transfer (Question 1 of the ED).

Detailed feedback analysis

Date of initial recognition or derecognition

2 Most respondents generally agreed with the IASB proposal in paragraph B3.1.2A of the ED to clarify the settlement date principle when recognising or derecognising financial assets and financial liabilities.

3 However, many respondents expressed concerns that reference to the application of settlement date accounting (as described in paragraph B3.1.6 of IFRS 9) when read in combination with the general principle in paragraph 3.1.1 of IFRS 9, may have unintended consequences, resulting in further diversity in practice, in particular:

(a) when applying the proposed requirements to derivatives; and

(b) the interaction between the requirements for settlement date accounting as described in paragraph B3.1.6 and section B32 of the Implementation Guidance to IFRS 9.

Applying the proposed requirements to derivatives

4 Many respondents expressed concerns that the IASB proposals are inconsistent with the general recognition principle in paragraph 3.1.1 and the related application guidance in paragraphs B3.1.1–B3.1.2 of IFRS 9 and it was unclear how they would apply to derivatives.

5 In particular, these respondents referred paragraphs B3.1.2(c) and B3.1.2(d) as examples where the reference to the settlement date is often not relevant as there will be no delivery of cash or another financial asset at inception. Instead, in these examples, financial assets or liabilities are recognised on the commitment date which is in line with their contractual status.

6 A few respondents also noted the potential impact of paragraph B3.1.2A on their accounting treatment for short sale transactions.

Interaction between settlement date accounting and Implementation Guidance

7 When commenting on paragraph B3.1.2A many respondents observed that settlement date accounting as described in paragraph B3.1.6 of IFRS 9 refers only to financial assets and not to financial liabilities.

8 As a result, many respondents queried how to apply the requirements regarding settlement date accounting to the recognition and derecognition of financial liabilities, especially given that in the view of some the requirements in paragraphs 3.3.1 and B3.3.1 of IFRS 9 are based on legal extinguishment rather than on settlement date accounting.

9 Some other respondents pointed out that section B32 of the Implementation Guidance to IFRS 9 states that there are no specific requirements on applying settlement date accounting to financial liabilities. As a result, the proposed requirements cannot reference to paragraph B3.1.6 of IFRS 9 which only describes settlement date accounting for financial assets. In their view, paragraph B3.1.2A should be removed as it provides new and not clarification of existing requirements.

Derecognition of financial liabilities

Scope

Limitation to electronic payment systems

10 Some respondents suggested that the proposed requirements should also include other means of payment, such as cheques or similar transactions and should not be limited to transfers using an electronic payment system, because it would significantly change current accounting outcomes which are long-standing established industry practice.

11 A few respondents stated that excluding cheques from the scope of the proposed requirements would implicitly create a new requirement whereby entities will need to confirm with a counterparty if cash for the settlement of a financial liability has been received before it could be derecognised.

Limitation to financial liabilities

12 Some respondents said that similar requirements for the derecognition of financial assets are needed as this was the fact pattern originally submitted to the IFRS IC. The considered that it would be a change to industry practice in particular in relation to cheques and credit card receivables. In addition, it would create inconsistence between intercompany balances.

13 Few respondents noted that this would result in changes to current practice of accounting for ‘cash in transit’ because it is not clear whether it would meet the definition of a cash equivalent (feedback suggests that current practice is to reclassify trade receivables to cash in transit receivable once they’ve been notified that the counterparty has made a payment instruction), another financial asset, or something else.

14 In addition, it is unclear where these balances should be presented in the cash flow statement. Therefore, these respondents recommended that the IASB should either delay the amendment to consider these issues or should add them to another broader project that considers issues in relation to IAS 7 *Statement of Cash Flows* (for example, the *Statement of Cash Flows and Related Matters* project).

Proposed criteria for derecognising a financial liability before the settlement date

15 Most respondents agreed with the proposed criteria in paragraph B3.3.8 of the ED, but some respondents stated that they set too high a threshold to overcome in practice, resulting in the proposals being of little practical benefit.

Paragraph B3.3.8(a) - No ability to withdraw, stop or cancel the payment instruction

16 Many respondents noted that the proposed requirements as drafted will result in nearly all electronic payment system not meeting the requirements, because of the protective rights inherent in an electronic payment system such as an ability to recall the payment in the case of fraud or technical error. In their view, 'ability' appears to be an absolute requirement (with possible legal implications) and determining the point where there is no absolute ability to cancel a payment instruction is operationally complex, particularly for cross-border transactions and may vary by instructing bank or electronic payment system(s) used.

17 Therefore, it was suggested to either remove that requirement or to align it to the requirement in paragraph B3.3.8(b) to refer to practical ability.

Paragraph B3.3.8(b) - No practical ability to access the cash used for settlement

18 A few respondents noted that it was unclear how the proposed requirements would apply to a payment instruction settled by way of an overdraft or other similar facility with a negative balance and if this refers to the broader definition of cash in paragraph 8 of IAS 7. They suggested to include such facilities in scope of the proposed requirements.

19 A few respondents were concerned that the proposed clarification in paragraph B3.1.2A and the requirements in paragraph B3.3.8 of the ED could result in situations where users could be misled about the amount of cash at the reporting date if an entity initiates many payment instructions before the reporting date but do not apply the requirements in proposed paragraph B3.3.8. They questioned whether paragraph 48 of IAS 7 requiring to disclose significant cash balance held by the entity that is not available for use by the group would apply to such a situation.

20 A few other respondents said payment systems typically allow a customer to prepare a transaction in advance and normally there is not a requirement that funds are available before the payment is actually initiated. They were unclear whether the proposed requirement in paragraph B3.3.8(b) of the ED implicitly would not permit such an approach as it refers to the entity's practical ability to access the cash.

Settlement risk

21 Most respondents generally agreed that the settlement risk with the electronic payment system should be insignificant, but some asked for more guidance of what is meant by 'settlement risk', 'short' period and 'standard administrative process' in the proposed paragraph B3.3.9 of the ED.

22 A few other respondents were of the view that the requirement for settlement risk to be insignificant might not be needed. This is because the other requirements related to the entity not having the practical ability to access the cash or to withdraw the payment instruction already require the completion of the payment instruction not to be subject to the entity's ability to deliver the cash on the settlement date.

23 In contrast, a few other respondents specifically said that this criterion is needed to ensure that the proposed exception is applied only in the appropriate circumstances and not, for example, in situations where payment instructions are scheduled for a future date and subject to the entity having sufficient funds on that future date to honour the payment instruction.

Optional adoption on a system-by-system basis

24 A few respondents suggested that the proposed requirements should be applied on an 'all-or-nothing' basis to all electronic payment systems that meet the criteria to avoid the potential for abuse. Specifically, they were concerned that such a practice

may result in similar transactions being treated differently by an entity that uses similar (but different) payment systems.

25 A few other respondents noted that the application of the proposed requirements could vary by type of payment transaction within the same electronic payment system which in their opinion would not be appropriate and not result in useful financial information.

26 A few respondents stated that it is not clear whether an assessment is required to be performed at payment initiation only or continuously to determine when the liability could be derecognised.

Operational effects on information technology

27 A few respondents noted that significant time may be needed to analyse the existing payment systems (across jurisdictions, cross-border and domestic payments, etc) in the scope of the amendments and suggested separating finalisation of the proposed amendments from the rest of the ED to allow more work to be performed.

Other observations

28 Other comments made by respondents included:

(a) specifying that when a financial liability is derecognised before the settlement date, the corresponding cash amount is also derecognised and that this also extends to the presentation of cash in accordance with IAS 7; and

(b) defining 'electronic payment system', including whether the assessment is based on the contractual rights and obligations only or also considers any statutory rights and obligations that might apply.

IASB staff analysis

Date of initial recognition or derecognition

Application of the general requirements

29 The IASB staff acknowledged stakeholder feedback that references to settlement date accounting might appear to be inconsistent with other requirements in IFRS 9 and therefore could have unintended consequences.

30 As explained in paragraph B3.1.2 and section B32 of the Implementation Guidance to IFRS 9, an entity becomes a party to the contract when at least one of the parties has performed under the contract and as a result a legal right to receive or obligation to pay has been established (paragraphs B3.1.2(a) and (b) of IFRS 9).

31 In the IASB staff view, this is consistent with what is described in paragraph B3.1.6 of IFRS 9 in the context of regular way transactions as the settlement date, i.e. one of the parties to the contract has performed by delivering the financial asset and therefore the other party has a right to receive or an obligation to pay cash.

32 Similarly, paragraphs 3.2.3 and 3.3.1 of IFRS 9 require a financial asset or financial liability to be derecognised when the right to receive cash expires or the obligation to pay cash is extinguished. For financial liabilities, this is illustrated in paragraph B3.3.1(a) which states that a financial liability is extinguished when an entity discharges the liability by paying the counterparty either in cash or another financial asset or by delivering goods and services.

33 Therefore, the IASB staff concluded that 'settlement date' refers to the date on which an entity's right to receive or obligation to pay cash is established or extinguished. In other words, a financial asset is derecognised when the entity no longer has the right to receive cash (or another financial asset) either because it has received the cash (or another financial asset) and therefore the right has expired or the right to receive cash has been transferred. Equally, a financial liability is derecognised when

the obligation is extinguished either because the entity has delivered the cash (or another financial asset) or the obligation has been cancelled.

34 With regards to derivatives, the right to receive and obligation to pay cash are typically established when the parties commit to the contract, i.e. the commitment date (paragraphs B3.1.2(c) and (d) of IFRS 9). Therefore, for derivatives the commitment date (also sometimes called trade date) and the settlement date is the same date. This is because both parties have fulfilled their obligations under the contract on the commitment date and no part of the contract remains executory.

35 To avoid any unintended consequences that could result from referring to settlement date accounting, the **IASB staff recommend deleting the reference to settlement date accounting and replacing it with a reference to settlement date in a revised version of paragraph B3.1.2A of the ED along with an explanation that settlement date refers to the date on which the right to receive or obligation to pay cash (or another financial asset) is established or extinguished.**

Derecognition of financial liabilities

Scope

Limitation to electronic payment systems

36 The IASB staff acknowledge feedback about other means of payments such as cheques or similar transactions to be included in the scope. However, it notes that the original question to IFRS IC resulted from a nature of a payment method being used, i.e. electronic cash transfers (see paragraph BC37 of the Basis to Conclusions on the ED).

37 The IASB staff note that the proposed requirements in paragraph B3.3.8 of the ED is an exception to the general requirements in IFRS 9 and, therefore, they should apply to a limited scope of transactions or instruments. In addition, the IASB staff notes that the IASB considered but rejected enlarging the scope of the proposed amendments (see paragraph BC12 of the Basis to Conclusions on the ED).

38 The IASB staff further note that underlying rationale for the proposed criteria in paragraph B3.3.8 of the ED is that, after a payment instruction has been initiated and the entity has no [practical[1]] ability to withdraw the instruction, the completion of the payment (i.e. delivering the cash) is subject only to a standardised administrative process and not to settlement risk. Electronic payment systems establish a controlled environment for cash transfers so that the risk of the cash not being delivered to the creditor is minimal (or de minimis).

39 In the IASB staff view, **other payments methods**, such as cheques, **do not provide insignificant settlement risk before the cash is delivered and, hence, cannot be included in the scope.**

Limitation to financial liabilities

40 The IASB staff also acknowledge feedback that the scope of the proposed exception should be extended to the derecognition of financial assets (for example trade receivables) and the recognition of a 'cash-in-transit' financial asset once payment has been advised.

41 When developing the proposed requirements in paragraph B3.3.8 of the ED, the IASB considered whether a similar exception to the general derecognition criteria for financial assets could be developed but decided not to proceed (see the IASB AP 16B for November 2022 meeting).

[1] The IASB staff proposal.

42 This is because for financial assets, there is no equivalent notion of having no [practical] ability to withdraw or cancel a payment instruction. Equally, the criteria cannot be based on requiring an entity to know when a counterparty has no [practical] ability to withdraw a payment instruction as the recognition of a financial asset is based on the entity's contractual right to receive cash and derecognition is based on the expiry of the right to receive and not that of the counterparty. Therefore, a confirmation from the creditor that a payment instruction has been initiated, does not lead to the expiry of the right to receive cash. It is only once the cash is received that such a right expires.

43 Therefore, in the IASB staff view, **this exception cannot be applied to financial assets.**

Proposed criteria for derecognising a financial liability before the settlement date.

Paragraph B3.3.8(a) - No ability to withdraw, stop or cancel the payment instruction

44 The IASB staff acknowledge respondents' concerns about the practicality of the criterion in paragraph B3.3.8(a) of the ED and agree that it would likely result in the proposed exception having no practical effect as the criteria might never be met.

45 Therefore, the IASB staff recommend **aligning the requirement in paragraph B3.3.8(a) with the one in paragraph B3.3.8(b) so that both refer to 'practical ability'** to access the cash. In the IASB staff view, the term 'practical' does not need further explanation as it is already used in the relevant section of IFRS 9 (e.g., paragraph 3.2.9 of IFRS 9).

Paragraph B3.3.8(b) - No practical ability to access the cash used for settlement

46 The IASB staff is of the view that 'cash' in the proposed requirements has the same meaning as used throughout IFRS 9 and IAS 32 and not a broader definition used in paragraph 8 of IAS 7. Therefore, further explanations are neither necessary nor helpful as this could have the potential for unintended consequences.

47 The IASB staff further refer to the explanation in paragraph BC37 of the Basis for Conclusions on the ED that the practical challenges that lead to the development of the proposed exception, did not relate to the nature of the account from which a payment is made and consider that it also includes the nature of the cash being used.

48 The IASB staff equally **does not consider that any refinements are needed for the future payments prepared in advance**. This is because when a payment instruction that is prepared for a future payment that will be made, it will most likely not meet the requirements for the financial liability to be deemed to be discharged because such instructions can usually still be withdrawn, cancelled or amended and the entity does not lose the practical ability to access the cash.

Settlement risk

49 The IASB staff notes that settlement risk is described in paragraph BC33 of the Basis for Conclusions on the ED[2]. For a financial liability to be derecognised before the settlement date, the counterparty must no longer be exposed to risk of non-payment by the debtor. Paragraph B3.3.9 of the ED proposes application guidance when that is the case using the terms 'short' and 'standard administrative process' both of which support the notion of eliminating settlement risk.

[2] 'Settlement risk' generally refers to the risk that a transaction will not be settled (or completed) and therefore that the debtor will not deliver cash to the creditor on the settlement date. For the purposes of the requirements in paragraphs B3.1.6 and B3.3.1 of IFRS 9, when a financial liability has been discharged by paying cash to a creditor, the creditor is no longer exposed to any settlement risk associated with the transaction.

50 The IASB staff does not consider that further clarifications of these notions are needed as it might involve setting an arbitrary threshold with regards to the number of days. Therefore, it **does not recommend any changes to paragraph B3.3.9 of the ED.**

Operational considerations

Definition of an electronic payment systems

51 The IASB staff acknowledges that there is no definition of electronic payment system in the ED, but notes, referring again to paragraph BC37 of the Basis for Conclusions on the ED, that it is the nature of the payment method rather than an exact definition of the system used which is important when applying judgement.

52 With regards to whether continuous reassessment of a payment system's criteria is required, the IASB staff considers that any changes in terms and conditions, that govern the payment system, will trigger a need to reassess whether that system still meets the criteria. However, this does not mean an entity needs to continuously reassess between the payment initiation date and the settlement date whether the criteria are met.

53 With regards to suggestions to apply the proposed requirements on an 'all-or-nothing' basis rather than on a system-by-system basis, the IASB staff do not see the potential for abuse of the proposed requirements.

54 Making the application of the exception subject to an assessment of all payment systems to identify which ones meet the requirements could be quite onerous because each system needs to be assessed individually. In addition, this will also require additional requirements to be developed for when an entity starts to use a new electronic payment system or when one payment system ceases to satisfy the criteria.

55 The IASB staff, therefore, recommend **not making any changes to the proposed requirements in this regard.**

The corresponding 'credit'

56 In the IASB staff view, the corresponding derecognition of the cash when the proposed criteria in paragraph 3.3.8 of the ED are met is consistent with the IASB's intention behind the proposed exception. This is because, when the proposed requirements are met, the entity concludes that it has no practical ability to access the cash to be used for settlement. By deeming the liability as discharged through such electronic transfer, an entity also deems the right to the cash flows of the financial asset to be expired once it loses its practical ability to access it.

57 In addition, recognising another financial liability (such as a payable for the cash to be delivered) rather than derecognising the cash would raise the same questions about the current practice of accounting for so-called 'cash in transit' and the IASB staff believes it is not a proper way to account for rights and obligations of these items.

58 With regards to comments about the potential for users of financial statements to be misled about the amount of cash at the reporting date if an entity initiates many payment instructions before the reporting date but do not apply the requirements in proposed paragraph B3.3.8, IASB staff acknowledge that paragraph 48 of IAS 7 require disclosure of the amount of encumbered cash at the reporting date. There are also other requirements in IFRS 7 and IAS 1 that require an entity to disclose information that is needed for users of financial statements to understand the nature, amount and timing of future cash flows.

Effects on information technology

59 IASB staff acknowledge the respondents' concerns about potentially requiring a **long transition period** to apply the proposed requirements in paragraphs B3.3.8 and B3.3.9 of the ED, compared to the other proposed amendments and notes that it will be **taken into consideration when considering feedback on the proposed effective date and transition requirements for the proposals in the ED.**

The IASB discussion

60 All 13 IASB members present **voted in favour** of the IASB staff recommendations, noting that these were practical answers to the comments received from stakeholders.

61 Members found the reference to the settlement date helpful, in particular a direct link to derecognition requirements when obligation is extinguished.

62 Members were also supportive of the narrow scope of the amendments, noting that including financial assets or other payment methods would extend the project for several years.

63 One member expressed a particular support for further considering 'cash in transit' items within the broader IASB project, such as *Statement of Cash Flows and Related Matters*.

64 On the intercompany reconciliations, it was noted that it is not the first time the asymmetry is created between the individual entities accounts, for example this is the case for the lessor and lessee accounting in IFRS 16 *Leases* and that looking at the reporting entity perspective was important.

The EFRAG Secretariat assessment

65 The EFRAG Secretariat notes that the IASB staff has proposed very limited refinements to the original proposals.

66 The EFRAG Secretariat supports the IASB staff recommendation to align the wording in paragraph B3.3.8(a) with the one in paragraph B3.3.8(b) so that both refer to 'practical ability', it is in line with EFRAG recommendation in its comment letter.

67 The EFRAG Secretariat considers the IASB proposals to refer to and to provide explanation about settlement date useful, but questions whether they will effectively resolve all the concerns raised by respondents.

68 The EFRAG Secretariat notes that there may be possible confusions between settlement date accounting (applicable to recognition and derecognition of financial assets in a regular way purchase or sale) defined in paragraph B3.1.6 of IFRS 9 as 'the date that an asset is delivered to or by an entity' and settlement date (applicable to recognition and derecognition of financial assets and financial liabilities in general) to be explained in paragraph B3.1.2A as 'the date on which the right to receive or obligation to pay cash (or another financial asset) is established or extinguished'.

69 Overall, the EFRAG Secretariat supports the IASB approach of keeping the practical exemption to the derecognition principle limited. The EFRAG Secretariat notes that the need for this exemption will fall away when the banking settlement systems globally become "live" or down to a matter of "overnight" or less which is already the case for large parts of the EEA.

EFRAG discussions

70 EFRAG FIWG and IAWG discussed this topic at its meetings on 20 and 21 November 2023, respectively. Their feedback is provided below.

EFRAG FIWG

71 EFRAG FIWG members expressed support for the IASB proposals, in their view a more conceptual discussion would result in a much bigger project.

72 Some member considered that overdrafts should be included in the scope of the IASB proposals.

EFRAG IAWG

73 EFRAG IAWG members noted that this issue is not pervasive for insurance companies, but expressed disappointment by the limited scope chosen by the IASB. Some members suggested that IASB considers extending this exception to the assets side and other payment methods in a future project that should be added to the IASB workplan.

Questions for EFRAG FR TEG

74 Does EFRAG FR TEG have any comments on the feedback analysis of the Question 1 of the ED?

75 Does EFRAG FR TEG agree with the IASB staff recommendation in paragraph 35 to delete the reference to settlement date accounting and replace it with a reference to settlement date in a revised version of paragraph B3.1.2A of the ED along with an explanation that settlement date refers to the date on which the right to receive or obligation to pay cash (or another financial asset) is established or extinguished?

76 Does EFRAG FR TEG agree with the IASB staff recommendation in paragraph 45 to align the requirement in paragraph B3.3.8(a) with the one in paragraph B3.3.8(b) so that both refer to ‘practical ability’?

77 Does EFRAG FR TEG have any comments on the other topics of Question 1 of the ED where the IASB staff did not recommend any changes?