UKEB
UK Endorsement Board

Summary of the Financial Instruments Working Group meeting held on 16 January 2024 from 2pm to 5pm

Meeting agenda

Item no.	Item
1	Welcome
2	Technical discussion: *Financial Instruments with Characteristics of Equity*
3	Horizon scanning
4	Technical discussion: *Amendments to the Classification and Measurement of Financial Instruments*
5	Technical discussion: *Power Purchase Agreements*
6	Any other business

Attendees

Present	
Name	**Designation**
Peter Drummond	Chair, Financial Instruments Working Group (FIWG)
Alan Chapman	FIWG member
Brendan van der Hoek	FIWG member
Conrad Dixon	FIWG member
Fabio Fabiani	FIWG member
Helen Shaw	FIWG member

Mark Randall	FIWG member
Mark Spencer	FIWG member
Richard Crooks	FIWG member (for sessions 1-3 only)
Sarah Bacon	FIWG member (by dial-in)
Stacey Howard	FIWG member
Ian Mitchell	Observer (by dial-in)

In attendance	
Name	**Designation**
Pauline Wallace	Chair, UK Endorsement Board (UKEB)
Sandra Thompson	Board member, UKEB (by dial-in)
Seema Jamil-O'Neill	Technical Director, UKEB

Apologies: Kumar Dasgupta (FIWG member) and Robbert Labuschagne (FIWG member).

A member of the Financial Reporting Council - Corporate Reporting Review team was present.

EFRAG project team members were present for the second agenda item 'Technical discussion: *Financial Instruments with Characteristics of Equity'* only.

Relevant UKEB Secretariat team members were also present.

Welcome

1. The Chair of the FIWG welcomed members, the observer and those in attendance to the meeting.

Technical discussion – *Financial Instruments with Characteristics of Equity*

2. The objective of the session was to discuss a skeleton paper setting out Secretariat proposed responses to the IASB's questions accompanying the Exposure Draft (ED) on *Financial Instruments with Characteristics of Equity* (FICE) and questions for FIWG members. The paper had been drafted based on the December 2023 UKEB Board discussion, outreach to date with several UKEB

advisory groups, and targeted stakeholder engagement. The Chair invited views on the skeleton proposed responses.

Effects of laws

3. In the ED, the IASB had proposed requiring entities to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law.

4. During the discussion, the following points were made:

   a) It was unclear why ED paragraph 15A(b) was included, as it appeared to duplicate the requirements in ED paragraph 15A(a).

   b) The proposals in the ED did not cover scenarios where laws or regulations provided a choice, for example, on the form a loss absorption feature could take.

   c) Prohibiting disaggregation of the obligation was a pragmatic solution. Although that approach was not necessarily consistent with requirements elsewhere, dividing an obligation into components would not necessarily provide meaningful information to investors and could create difficulties, for example, if the law changed.

Fixed-for-fixed condition

5. The IASB has proposed clarifications on applying the 'fixed-for-fixed' condition. Where the amount of consideration to be exchanged for each of an entity's own equity instruments is variable, it should vary only with either 'preservation adjustments' or 'passage-of-time adjustments'. The ED appears to prohibit instruments linked to benchmark rates from meeting this condition.

6. FIWG members considered that although the wording might be inelegant, the intended meaning of ED paragraph 22C(a)(ii) on preservation adjustments was sufficiently clear.

7. FIWG members noted that clarification on the meaning of 'proportional', both through additional explanation and illustrative examples including instruments that both pass and fail the condition, would be welcome. Under current practice in the UK, financial instruments linked to benchmark rates of inflation or interest would typically be considered to meet the fixed-for-fixed condition. FIWG members considered the proposed requirements were overly restrictive in relation to instruments linked to benchmark rates.

Obligations to redeem own equity

8. The IASB has proposed several clarifications on accounting for obligations to redeem own equity. The FIWG principally discussed the measurement proposals contained in paragraph 23 of the ED.

9. During the discussion, the following points were made:

   a) FIWG members considered that the proposals would enhance the comparability of financial reporting. On instruments with features linked to EBITDA, entities would increase the liability resulting from the obligation to redeem own equity, as profits accrued, a common practice at present.

   b) If additional information was needed to explain an unusual outcome under this requirement, it was considered that IAS 1 *Presentation of Financial Statements* might require disclosure of such information. If not, a specific disclosure requirement might be warranted.

Contingent settlement provisions

10. Among other requirements in this area, the IASB has proposed that contingent settlement provisions should be measured at the "*present value of the settlement amount*" (ED paragraph 25A).

11. During the discussion, the following points were made:

    a) The scope of these provisions was not clear and could potentially appear to apply to tax or law change clauses as well as loan covenants. They should be restricted to the debt components of compound instruments. Doing so would reduce the number of application questions which arise in relation to day-1 losses. Guidance remained welcome in that area.

    b) An alternative was to delete ED paragraph 25A, such were the potential issues with scoping.

12. FIWG members agreed that if the requirements remained as proposed, disclosure requirements would be important.

Reclassification

13. The IASB has proposed prohibiting reclassification of financial liabilities and equity instruments after initial recognition except when paragraph 16E applies or when it results from changes in circumstances external to the contract.

14. FIWG members had mixed views on whether these proposals would give rise to potentially misleading information. During the discussion, the following points were made:

a) Reclassification was not common in the UK. On the expiry or application of features with the passage of time, entities generally wished to reclassify instruments to provide users with an up-to-date position. These proposals would reduce diversity in practice.

b) Unintended consequences may arise from permitting reclassification. Not permitting instruments to be reclassified was consistent with the treatment in IFRS 17 *Insurance Contracts*.

c) However, some believed that not permitting reclassification under IFRS 17 had led to confusing classification of some insurance products in financial statements. It was not desirable that this treatment should extend to IAS 32 *Financial Instruments: Presentation*.

d) Not reclassifying non-derivatives could result in unexpected outcomes. In particular, preventing reclassification for non-derivatives in respect of contractual terms that become, or stop being, effective with the passage of time could result in the provision of potentially misleading information. The continuing recognition of a financial liability in such circumstances may no longer faithfully represent the substance of the financial instrument. Examples of these include the expiry of a contingent settlement provision and a change in terms with the passage of time that results in the instrument meeting the criteria for equity classification.

Disclosure

15. The IASB has proposed a series of disclosure requirements, including disclosures on the priority of claims against the entity on liquidation. During the discussion, the following points were made:

a) The priority on liquidation disclosures may not always be operable in a group context, as the required information may not be routinely collected on a consolidated level and may be difficult to assess or audit, especially for multinational groups that operate across jurisdictions with different legal frameworks.

b) It was difficult to assess at this stage whether meeting the proposed requirements would take undue cost or effort. Field testing the disclosures before finalisation of the requirements would provide better information on the costs and benefits of the disclosures proposed.

Transition

16. The IASB has proposed full retrospective transition, with a limited number of exceptions. During the discussion, the following points were made:

a) IFRS 16 *Leases* provided a practical expedient on transition allowing entities not to reassess whether contracts were, or contained, a lease at the date of initial application of the Standard.

b) When assessing shareholder discretion, it would be difficult to do so without hindsight.

c) If an instrument expired in the period before the amendments were effective, it should not be required to be reassessed.

d) The transition requirements should be considered in the light of the IASB's final decisions on reclassification.

Horizon scanning

17. The Chair asked for current or emerging issues in the financial reporting environment for financial instruments, that members considered warranted discussion during this or a future meeting.

18. Members discussed briefly the IFRS Interpretations Committee *Tentative Agenda Decision (TAD): Climate-related Commitments (IAS 37)*. Overall, FIWG members expressed no concerns in relation to the Committee's conclusion in the TAD; however, it was noted that more needed to be done to help users of accounts understand the linkage between an entity's sustainability narrative disclosures and its financial statements.

Technical discussion: *Amendments to the Classification and Measurement of Financial Instruments*

19. The IASB re-deliberations on the proposed amendments Exposure Draft *Amendments to the Classification and Measurement of Financial Instruments* (the ED) are ongoing. Papers summarising the October and November 2023 IASB staff papers on this topic, and the associated IASB tentative decisions, had been provided to FIWG members. The Chair invited views on the IASB's work to date in this area.

Derecognition of financial liabilities through electronic transfer

20. In November 2023, the IASB tentatively decided to finalise the proposed amendments in the ED, subject to:

    a) deleting the reference to 'settlement date accounting' in paragraph B3.1.2A of the ED and replacing it with 'settlement date' and 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; and

b) aligning the requirements in paragraphs B3.3.8(a) and B3.3.8(b) of the ED so that both refer to 'practical ability'.

21. In the ensuing discussion the following matters were raised:

a) Members agreed that the inclusion of the phrase "practical ability" was helpful in clarifying the IASB's intention and provides consistency between the elements of the test at paragraph B3.3.8.

b) It was unclear if these proposals were sufficient to permit the pragmatic response, outlined in the UKEB comment letter, of "instruction date" derecognition (i.e. derecognition at the time the qualifying electronic payment is instructed). Some considered the alternative accounting offered was still complex, and would require detailed analysis for each payment system. As such there was likely to be more limited take-up of this option than under an instruction date method. Stakeholders needed to consider how the new drafting will be interpreted once the tentative decision is finalised. One member noted that by scheduling payments to allow time for settlement prior to the end of the reporting period, any issues related to the timing of derecognition at period end could be avoided.

c) Some members felt the treatment of overdrafts in these proposals remained unclear. This was not expected to be a significant issue for banks but may impact corporates.

d) It was expected that, once drafted, the revised Basis for Conclusions would provide clarity on the status of the original IFRS Interpretations Committee tentative agenda decision on the derecognition of assets.

e) The group identified no significant issues that the IASB would need to resolve prior to finalising these proposals.

Equity instruments and other comprehensive income

22. In November 2023 the IASB tentatively decided to finalise the proposed amendments in the ED, subject to:

a) amending the introductory sentence in paragraph 11A of IFRS 7 *Financial Instruments: Disclosures* to require an entity to apply the disclosure requirement in that paragraph per 'class' of equity investment; and

b) including in paragraph 11B of IFRS 7 a disclosure requirement similar to that in paragraph 11A(e) of IFRS 7.

FIWG members raised no concerns on these proposals.

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

23. In October 2023, the IASB discussed stakeholder feedback received specifically on Question 2 of the ED about contractual terms that are consistent with a basic lending arrangement. At that meeting the IASB staff also presented an analysis and recommendations on how to address the feedback received. The IASB was not asked to make any decisions.

24. In the ensuring discussion the following matters were raised:

    a) Members noted that the IASB had listened to the feedback provided during the ED consultation. They were in favour of the holistic, principles-based approach described in the IASB staff papers.

    b) It was agreed that the IASB needed to continue its work on the detail of the proposals before final conclusions could be drawn. However, the overall direction of travel was encouraging.

    c) The concept of an "insignificant" fair value was discussed. Some members thought it was unclear what the comparator should be to determine insignificance. Examples of potential comparators discussed included the fair value of the loan principal and the fair value of the profit margin. Some felt there was risk that this requirement may end in a similar place to the existing de minimis analysis. It was noted that the insignificant fair value test may not always lead to the result intended by these proposals. For example, an instrument could have significant positive and negative cashflows that net to nil fair value.

    d) It was agreed that removing the "specific to the debtor" criteria was a positive outcome that would help avoid unintended changes to existing practice.

    e) The potential effective date was discussed, noting that 1 January 2026 was the most likely proposal. No FIWG member expressed concerns with this.

Technical discussion: Power Purchase Agreements

25. The IASB has proposed to undertake urgent standard-setting in this area.

26. In the discussion, the following points were made:

    a) Both physical and virtual power purchase agreements (PPAs) were of increasing size and prevalence in the UK. The increase was largely due to companies looking to meet net zero commitments.

    b) For intermediary entities, the accounting implications can be complex.

c) There was a discussion on how guidance might be provided on the application of the 'own use' requirements in IFRS 9 *Financial Instruments* to physical PPAs to reflect certain unique characteristics that might otherwise present challenges with the application of those requirements.

d) Although virtual PPAs provided good economic hedges, it was noted that it was difficult for them to meet the current hedge accounting requirements, for example, owing to the long-term nature of the contracts.

e) It was thought that the task of amending the hedge accounting requirements would prove more difficult than scoping an 'own use' exception.

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27. There being no other business, the meeting closed.