Summary of the Financial Instruments Working Group meeting held on 6 June 2023 from 2pm to 5pm

Meeting agenda

Item no.	Item
	Welcome
1	IASB presentation: *Financial Instruments with Characteristics of Equity*
2	Forward agenda and horizon scanning
3	Technical discussion: *Amendments to the Classification and Measurement of Financial Instruments*
4	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
Kumar Dasgupta	FIWG member
Mark Randall	FIWG member
Mark Spencer	FIWG member
Richard Crooks	FIWG member
Sarah Bacon	FIWG member (by dial-in)
Stacey Howard	FIWG member
Ian Mitchell	Observer

In attendance	
Name	**Designation**
Pauline Wallace	Chair, UK Endorsement Board (UKEB)
Seema Jamil-O'Neill	Technical Director, UK Endorsement Board (UKEB)

Apologies: Robbert Labuschagne (FIWG member), Tim Dee (Observer).

Two IASB staff members joined the meeting for agenda item '1 - IASB presentation: *Financial Instruments with Characteristics of Equity*'.

Relevant UKEB Secretariat team members were also present.

UKEB
UK Endorsement Board

Welcome

1. The Chair of the Financial Instruments Working Group (FIWG) welcomed members to the meeting and introduced the new member, Stacey Howard, to all members in the group.

IASB Staff Presentation - *Financial Instruments with Characteristics of Equity*

2. The IASB staff gave a presentation on the IASB's *Financial Instruments with Characteristics of Equity* (FICE) project, which is targeting the release of an exposure draft in Q4 2023. The staff began with an overview of the project, including objective and timeline, then focused on three specific topics as follows:

    a) Effects of laws on contractual terms.

    b) Financial instruments with contingent settlement provisions.

    c) Obligations to redeem own equity instruments.

Effects of laws on contractual terms

3. The IASB staff noted that the IASB had tentatively decided that financial instruments should be classified as financial liabilities or equity by considering only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by relevant laws.

Explicitly stated contractual terms

4. The IASB staff clarified that for purposes of classifying a financial instrument either as debt or equity, an entity would not consider laws and regulations that are replicated in the contract. However, an assessment might still be needed as to whether the contractual terms give rise to any other obligations (i.e., non-financial liabilities) that should be accounted for.

5. One FIWG member questioned whether the application of the tentative decision would result, in all cases, in the right accounting outcome. It was therefore suggested that a detailed assessment looking at individual instruments would be needed to test the proposals.

6. During the discussion some FIWG members noted that the IASB tentative decision seems consistent with other aspects of financial instruments accounting (that is, the treatment for bail-in instruments in IFRS 9 B4.1.13 Example E for purposes of assessing whether the cash flows are solely payments of principal and interest). However, inconsistencies were noted with the requirements in other IFRS Accounting Standards, such as IFRS 17, where an entity needs to consider laws and regulations. FIWG members therefore suggested the Basis for Conclusions

should be clear and acknowledge differences with other IFRS Accounting Standards, where applicable.

Terms not found in the contract

7. The IASB staff noted that when laws prevent enforceability of contractual terms, that should be taken into consideration for the purposes of assessing the classification of a financial instrument. This would apply, for example, if an instrument was contractually redeemable at the option of the holder but the law prohibited such a redemption. That instrument would be classified as equity as the entity would have no obligation to pay cash.

8. On the other hand, if the law creates obligations (such as a minimum dividend payment) regardless of whether or not such obligation is included as part of the contractual terms, the entity should not take that into account for purposes of the classification of that instrument as debt or equity.

9. Some FIWG members questioned the potential effects of the IASB's tentative decision on instruments such as preference shares where the law prohibits dividend payments unless the entity has distributable profits. A detailed assessment would need to be performed to test the IASB proposals, including the interaction with the measurement requirements in IFRS 9 *Financial Instruments*.

Financial Instruments with contingent settlement provisions

10. The IASB tentatively decided to clarify that financial instruments with contingent settlement provisions may be compound instruments. The liability component of a compound financial instrument with contingent settlement provisions which could require immediate settlement if a contingent event occurs, is measured at the full amount of the conditional obligation. The same approach applies for both initial and subsequent measurement of a financial liability (or liability component), that is, the probability of the contingency happening is ignored. Measurement would be the full amount discounted from the earliest date that redemption can be required. This would be applicable to any liability to which paragraph 25 applies.

11. The IASB staff acknowledged some application challenges in terms of measurement, and they had suggested the IASB consider those as part of the research pipeline project 'Amortised Cost'.

12. For instruments where at inception the proceeds are allocated wholly to the liability component and the equity component is nil, the IASB clarified that an equity component still exists and that when dividends are declared those are recognised in equity. Some FIWG members noted potential implications could arise for current practice, for instruments such as those contingent on a change of control event, or contingent on an IPO, which are common in private equity.

13. The IASB confirmed that 'liquidation' refers to the point when an entity is in the process of permanently ceasing operations. If payment was only on liquidation,

then it would be classified as equity. A FIWG member noted that this assessment could be quite judgmental.

14. Lastly, in relation to the term non-genuine, the IASB confirmed that the application guidance refers to an event that is extremely rare, highly abnormal and very unlikely to occur. Therefore, the IASB confirmed that this is not just a probability assessment (that is, something could be unlikely but there might be a genuine reason for putting such a clause in the contract).

Obligations to redeem own equity instruments

15. The IASB staff presented the IASB tentative decisions addressing different practice questions on the accounting for obligations to redeem own equity instruments. The IASB also tentatively decided to introduce additional disclosure requirements for these obligations. Some FIWG members noted that these obligations are prevalent in the UK, in particular arising on business combinations.

Other topics

16. Other topics briefly mentioned during the discussion were the IASB tentative decisions on reclassifications and additional disclosure requirements, such as those requiring disclosure of priority on liquidation and disclosures of equity instruments that have debt-like features.

Forward agenda and horizon scanning

17. The FIWG chair invited views from the group on potential agenda items for the FIWG meetings in September and November.

September meeting

18. For the 7th September meeting, the following topics were suggested:

    a) IASB Post-implementation Review of IFRS 9 Impairment requirements; and

    b) IASB standard-setting project *Financial Instruments with Characteristics of Equity* (FICE), with an initial focus on the following:

        i. Reclassifications.

        ii. Measurement of contingent settlement provisions.

        iii. Disclosure requirements.

        iv. Rights issues.

        v. Clarification of factor-based approach/shareholder discretion.

November meeting

19. It was suggested that the group start discussions on the IASB's standard-setting project *Dynamic Risk Management* (DRM). Some members suggested inviting IASB staff for a presentation on this topic.

Horizon scanning

20. The FIWG will continue to monitor developments on the future narrow-scope standard-setting project *Application of the 'Own Use' exception in the light of current market and geopolitical questions* (IFRS 9 Financial Instruments).

Technical discussion

Introduction

21. The FIWG Chair introduced the UKEB's draft comment letter in response to the IASB's Exposure Draft (ED) *Amendments to the Classification and Measurement of Financial Instruments*.

22. The discussion would inform the UKEB's final comment letter, which the Board intended to consider at its July meeting.

Derecognition of financial Liabilities

B3.3.8 and B3.3.9 Alternative to settlement date accounting

23. The UKEB Secretariat invited views on:

    a) paragraphs B3.3.8 and B3.3.9, which provide an alternative to settlement date accounting for payments settled with cash using an electronic payment system; and

    b) the UKEB's proposed alternative in its draft comment letter, to allow derecognition of a financial liability at the point the instruction for the electronic payment is initiated.

24. In the ensuing discussion, the following points were highlighted:

    a) FIWG members considered the alternative to settlement date accounting as proposed in the ED and concluded that its complexity and disproportionate operational costs may lead to limited take-up.

    b) In relation to the UKEB's proposal of derecognising the financial liability at the time the payment instruction is initiated, FIWG members shared the following views:

        i. One member suggested that an alternative to the UKEB proposal

would be removing the criteria at paragraph B3.3.8 (a) as the cancellation feature of electronic payment systems is seldom used. This member considered it appropriate to derecognise the financial liability when the criteria at paragraphs B3.3.8 (b) and (c) are met.

ii. One member supported the UKEB proposal and agreed it was a simpler approach but noted concerns on the likelihood of it being accepted by the IASB.

iii. Another FIWG member supported the UKEB's proposal as a practical expedient but questioned whether additional clarity would be required on whether recalled transactions would be an adjusting event.

iv. One member commented on the challenges of implementing any accounting policy choice, including disruption to current practice and cost implications of analysing individual payment systems in different jurisdictions. Another member noted that derecognising at the point of payment instruction as suggested in the UKEB DCL would be simpler and would therefore address some of these concerns.

v. In support of the UKEB's proposal, FIWG members considered that allowing derecognition at the point the payment instruction is initiated would be consistent with good financial control of payment processing and that it was unnecessary to introduce complexity.

c) FIWG members considered a clarification on the scope of electronic payment systems would be helpful to enable consistent application.

d) In relation to the UKEB's suggestion at paragraph A7 of its draft comment letter, some members were supportive of the suggestion of removing the last sentence in paragraph B3.3.9. However, one member considered the intent behind that sentence was to guarantee there is no risk that cash will not be available on the settlement date, therefore it was necessary to keep this sentence in the standard.

Electronic payment systems

25. The common UK electronic payment systems are described in four categories in the UKEB draft comment letter:

a) Bank transfers – funds move shortly after a payment instruction (e.g. BACS, Faster Payments, CHAPS and SWIFT);

b) Bank transfers – regular payments arranged in advance (e.g. Direct Debit and Standing Orders);

c) Card based payments, including debit cards and credit cards; and

d) Other digital payment methods including Apple Pay, Google Pay and Paypal.

26. The UKEB Secretariat noted that the BACS system, one of the most used electronic payment systems in the UK, has a cancellation window of 24 hours approximately, while instructions under Faster Payments cannot be cancelled once sent. Given the criterion in paragraph B3.3.8(a) relates to the entity's ability to cancel the payment instruction, the timing for the derecognition of financial liabilities could be different depending on the electronic payment system used.

27. FIWG members agreed that the cancellation profile and other relevant features for the electronic payment systems in the UK as presented by the UKEB Secretariat were consistent with their understanding. Some members highlighted that increased complexity is expected for multinational institutions due to the number of electronic payment systems that are involved.

B3.1.2A Settlement date accounting

28. One member raised a specific concern about the lack of a definition of settlement date accounting for financial liabilities. Proposed paragraph B3.1.2A includes a cross-reference to paragraph B3.1.6 which discusses settlement date accounting in the context of financial assets only. The IASB should therefore define what settlement date accounting means for financial liabilities.

Classification of financial assets

Contractual cash flows that are solely payments of principal and interest

29. The UKEB Secretariat invited views on the ED's proposed clarifications on the elements of interest in a basic lending arrangement, which in part are designed to address loans with Environmental, Social and Governance (ESG)-linked features.

30. Members again observed that the proposals were not sufficiently clear to ensure consistent application and agreed that the IASB should provide further application guidance or illustrative examples.

31. One member suggested that, in assessing the contractual cash flows arising from an ESG-adjustment, an entity could consider such adjustment as part of the profit margin (a concept already in IFRS 9) and therefore consistent with a basic lending arrangement, provided that:

a) the transaction has been priced in a competitive market;

b) there is no leverage;

c) it does not represent an investment in the debtor; and

d) it does not represent an exposure to the performance of specified assets.

32. Another member did not consider it necessary to link the ESG-adjustment to a specific element of interest. The financial asset would be assessed by taking paragraph B4.1.10A as a starting point. Cash flow changes from the contingent event could be considered an element of interest if the contingent event met the requirements in paragraph B4.1.10A (i.e., it does not represent an investment in the debtor or an exposure to the performance of specified assets). It would then follow the test on direction and magnitude, considering whether there was leverage and whether cash flows changed in a sensible direction given the risks to which the bank was exposed.

33. Some members questioned the IASB's intent behind the 'direction and magnitude' test and its application and thought further guidance should be provided by the IASB.

34. During this conversation, the group noted potential challenges for auditing the information relevant to the SPPI assessment, such as demonstrating a direct link or correlation between the ESG risk and profit margin or the 'direction and magnitude' assessment, as well as providing audit evidence at the granular level that would be expected.

B4.1.10A "specific to the debtor"

35. In April, FIWG members expressed concerns in relation to proposed paragraph BC67 which states that a change in contractual cash flows due to a contingent event that is specific to the creditor or another party would be inconsistent with a basic lending arrangement. During that meeting, it was noted that certain loans with clauses in which increased costs can be passed onto a borrower could fail the SPPI criteria. FIWG members understood such clauses to be common in the UK.

36. Members were encouraged to share additional examples of contingent events in loan arrangements (prevalent in the UK) currently accounted for at amortised cost which might fail the SPPI test if the amendments were finalised as currently proposed.

Contractually linked instruments

37. In April, FIWG members noted concerns about the potential for abuse in applying proposed paragraph B4.1.20A, as it was felt that subsequent sales of tranches could change the nature of the structure post-inception.

38. The UKEB Secretariat presented three alternative approaches as to how to address this in the UKEB's draft comment letter:

a) to suggest adding a contractual term to restrict subsequent sales of tranches;

b) to suggest a re-assessment of the bilateral lending arrangement is required when there is a sale of any of the tranches; or

c) to take no further action.

39. The group noted that each approach has disadvantages as well as advantages.

40. Some FIWG members suggested either (i) a middle ground focusing on 'expectation' that tranches would not be sold or (ii) no further action. While it was acknowledged that management intentions are always difficult to audit, that would not be the first case when auditors were faced with those challenges. Precedents include auditing an entity's business model or auditing the 'own use' exemption in IFRS 9.

AOB

There being no other business, the meeting closed.