UK Endorsement Board

# Summary of Financial Instruments Working Group meeting

# 7 September 2023 - 2pm to 5pm

## Meeting agenda

| Item no. | Item |
|---|---|
| 1 | Welcome |
| 2 | IASB Post-implementation Review: IFRS 9 Impairment |
| 3 | Financial Instruments with Characteristics of Equity |
| 4 | Horizon Scanning |
| 5 | Any other business |

## Attendees

| Present | |
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| **Name** | **Designation** |
| Peter Drummond | Chair, Financial Instruments Working Group (FIWG) |
| Alan Chapman | FIWG member |
| Brendan van der Hoek | FIWG member |
| Conrad Dixon | FIWG member |
| Helen Shaw | FIWG member |
| Mark Randall | FIWG member (by dial-in) |
| Richard Crooks | FIWG member |
| Robbert Labuschagne | FIWG member |
| Sarah Bacon | FIWG member (by dial-in) |
| Stacey Howard | FIWG member |
| Ian Mitchell | Observer (by dial-in) |

Apologies: Kumar Dasgupta, Fabio Fabiani, Mark Spencer (FIWG members).

Relevant UKEB Secretariat team members were also present.

## Welcome

1. The Chair of the Financial Instruments Working Group (FIWG) welcomed members to the meeting.

## IASB Post-implementation Review IFRS 9 Impairment

2. The UKEB Secretariat introduced the topic, a fatal flaw review of the UKEB [draft] final comment letter to the IASB.

3. In the discussion, the following topics arose:

### Intra-group lending

4. The FIWG discussed the draft comments on intra-group lending. Although the group acknowledged application challenges arising in relation to intra-group lending, it also noted the difficulties for defining a simplified approach that would work in all scenarios. Specific comments included:

   a) One member noted that a potential enhancement to the requirements would be to allow a simplified approach where a lifetime loss could be permitted, for example, for intra-group receivables that are term-based. However, it was also acknowledged that intra-group receivables are commonly due on demand.

   b) Another member suggested the issue should be acknowledged in relation to its interaction with other standards. For example, does impairment of a loan to a subsidiary indicate potential impairment of the cost of investment in the subsidiary?

   c) However, another member observed that the existing requirements were suitable for intra-group lending in banking groups (e.g. ring-fenced and non-ring fenced banks in a group), and considered that the requirements should not be changed.

5. Overall, the FIWG considered this was not a significant issue that required highlighting in the covering letter to the IASB.

### Expected credit losses and procyclicality

6. FIWG members discussed the view raised by some UK banking stakeholders that IFRS 9 could result in over-estimating losses and hence excessive procyclicality. However, most members disagreed that the Standard created procyclicality and/or that there was evidence of procyclicality.

7. One member asked if there was evidence that expected credit loss (ECL) models consistently overestimated losses. Members noted that many of the provisions from the time of the Covid pandemic had been released, but that IFRS 9 had not yet been tested under all economic conditions, so this was still unclear. However, to date IFRS 9 had worked as it forced banks to look more critically at losses that were expected. Another noted that ECL was an estimate, that no model was likely to predict the exact figure, and that the disclosures give more information about this. One member noted that IFRS 9 ECL may be conceptually a better approach but there were downsides as it could create extra volatility in the income statement as was seen during Covid.

## Significant increases in credit risk

8. The FIWG discussed the requirement that when assessing significant increase in credit risk (SICR) a collective assessment may be necessary. FIWG members agreed that in the UK, companies performed collective assessments of SICR, as required by IFRS 9 paragraph B5.5.1. They had not observed significant diversity in practice and thought the existing guidance was clear.

9. One member noted there was inconsistency in practice arising from how the threshold of "significant" was interpreted. It was noted that banks were working together to be more consistent in this regard but considered further guidance was needed. As part of this, the topic of "absolute" and "relative" triggers for SICR was discussed as it had been suggested to the UKEB that the latter did not always align well to internal credit risk practices. That feedback had also noted that the SICR methodology was most successful with loan books, and there could be more simplification for other asset types.

10. FIWG members considered that asking for a different approach for specific types of assets would be a major change to the Standard and they would not recommend asking the IASB for that approach. A member recommended caution as there was data variability across entities in different jurisdictions and across industries that would result in diversity, for example, 'significant' could vary widely depending on an entity's business (e.g. a bank compared with an insurer). This view aligned with earlier FIWG discussions in which concern had been expressed regarding unintended consequences arising from change.

## Modifications and disposals

11. The Secretariat noted that feedback had been received that the IASB may be unlikely to engage with this topic (i.e. interaction of modifications, derecognition and ECL), as it had had opportunities to do so in the past but had chosen not to. However, as there is now an IASB pipeline project *Amortised Cost Measurement* covering aspects of this topic, FIWG members agreed this may be a good time to raise the issue.

12. Should the IASB consider the issues raised in this section, one FIWG member asked for guidance on the accounting for disposals of assets classified within Stage Two, in which different approaches could be taken. It was noted that this was a question affecting presentation in the statement of profit or loss.

## Applying the effective interest rate to the amortised cost of credit-impaired assets

13. FIWG members would welcome amendments to the Standard that make it clearer that IFRS 9 paragraph 5.4.1(b) permits entities to apply the effective interest rate to the amortised cost of credit-impaired assets before the beginning of the following period.

14. One member suggested amending the wording in the UKEB comment letter to recommend that stakeholders should be able to apply the EIR to the amortised cost balance of the loan immediately after the asset becomes credit-impaired. Rather than "*accommodated*", the letter could read "*explicitly acknowledged*" to reflect the fact that the Standard already implicitly permits this treatment.

15. It was observed that this topic may be better placed in the Measurement or Other Matters section of the letter.

## Post-model adjustments

16. FIWG members considered that the language in IFRS surrounding post-model adjustments was currently unclear and inconsistent. They preferred to use "*judgemental adjustments*", as defined within the 2022 Disclosure on Expected Credit Loss taskforce guidance.[1] They suggested referring to the definitions within that guidance for additional clarity.

## Other

17. Some FIWG members also suggested that further guidance arising from various strands of work performed in the UK may be of assistance to the IASB or benefit a wider audience (for example, the work undertaken regarding the use of weightings in forward-looking scenarios).

18. One FIWG member noted that additional guidance on the accounting for financial guarantees that are 'non-integral', would be welcome.

[1] The Taskforce on Disclosures about Expected Credit Losses September 2022 report.

# Financial Instruments with Characteristics of Equity (FICE)

## Fixed-for-fixed condition

19. A paper summarising the IASB's tentative decisions and setting out questions on the draft proposals had been provided to FIWG members. A FIWG member introduced the topic and the Chair invited views on the draft proposals.

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

    a) Several FIWG members noted that the current exception on rights issues in IAS 32 *Financial Instruments: Presentation* paragraph 16 (b) (ii) should be retained. However, one FIWG member wondered whether the need to preserve the exception for rights issues indicated that there may be a weakness in the foundation principle[2] (that the number of functional currency units to be exchanged with each underlying equity instrument must be fixed or only vary with allowable preservation adjustments or passage of time adjustments).

    b) There was general agreement that the scope of the exception should not be extended. One FIWG member observed that, given the scope of the FICE project is to make "*clarifying amendments*"[3] to IAS 32, it would not be appropriate to reconsider that exception within this project.

    c) One member considered that this issue did not arise so much from IAS 32 as from IAS 21 *Effects of Foreign Exchange in Financial Statements*, which does not contain the concept of a group functional currency.

    d) In relation to the allowable preservation adjustments it was noted that the assessment is not probability based, so *any* possible scenario in which a future shareholder may benefit more than an existing shareholder under any circumstance will render that adjustment non-allowable. Some members felt that assessing *any* possible scenario without considering probability was a very strict test and one member considered that 'intention' should be factored in.

    e) In respect of 'allowable' passage of time adjustments[4], FIWG members also questioned whether the concept of present value could be distinct from the time value of money.

    f) Another FIWG member questioned the order in which the new principles and the existing requirements are applied and whether this was intended to be an 'either/or' test.

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2 See the IASB April 2020 staff papers 5A paragraph 5 and 12 to 31 on this topic.
3 See the current stage of the project, as set out by the IASB.
4 See the IASB April 2020 staff paper 5B paragraphs 4 to 6 and 20 to 25 on this topic.

21. Overall, members considered that the clarification of the fixed-for-fixed principle would reduce diversity in practice. However, the precise wording in the exposure draft will be important.

## Reclassifications

22. A paper had been provided to FIWG members setting out the IASB's tentative decisions and raising some questions about their application. A FIWG member introduced the topic, and the Chair invited views on the draft proposals.

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

    a) The accounting firms' manuals currently require reclassification in several situations. Under these proposals[5], the Standard would prohibit reclassification from equity to debt in all circumstances except those where changes in the contractual terms were caused by changes in circumstances outside the contract.

    b) Some FIWG members considered that few changes in circumstances outside the contract would impact on equity classification. The main examples were a change of functional currency and an entity leaving the group. Another FIWG member considered that the definition would appear narrow until something unexpected arose. A further FIWG member suggested that educational guidance on these specific scenarios may be useful as the proposals introduced a broader principle "outside the contract".

    c) One FIWG member considered that the change would achieve consistency, but equally expressed concern that preventing reclassification due to the passage of time could result in misleading information, particularly for non-derivatives. The interaction between IAS 32 paragraph 23 and the new proposals was not clear.

    d) One FIWG member noted that the IASB staff drew an analogy with the requirements in IFRS 9 *Financial Instruments* for classification of financial assets (paragraphs 4.1.2 to 4.1.5). Under those paragraphs, instruments are classified at inception and are not generally subsequently reassessed. Classification on the balance sheet does not therefore always reflect prospective characteristics. Another FIWG member commented that the effect of those paragraphs in IFRS 9 was on measurement, but that the instrument was always a financial asset. Reclassification between debt and equity was a more fundamental question than that of measurement.

    e) Another FIWG member observed that the proposed approach appeared consistent with other standards, such as IFRS 15 *Revenue arising from*

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[5] See IASB June 2022 agenda papers 5A Reclassifications and 5B Reclassifications.

*Contracts with Customers*, IFRS 16 *Leases* and IFRS 17 *Insurance Contracts*. For example, in IFRS 17[6], it is not possible to reclassify a contract between the variable fee approach and the general measurement model.

24. The Chair concluded that it would be necessary to continue considering the proposals and that the Secretariat would welcome further examples to test the proposals.

## Obligations to redeem own equity

25. A paper setting out the IASB's tentative decisions and introducing some questions on the draft proposals had been provided to FIWG members. A FIWG member introduced the topic, and the Chair invited views on the draft proposals[7].

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

    a) Overall, the clarifications were welcome as they would reduce diversity in practice; however, the proposals on measurement raised some concerns.

    b) The IASB has proposed that an entity is required to use the same approach for initial and subsequent measurement for financial liabilities within the scope of IAS 32 paragraph 23. FIWG members considered that this proposal highlighted the risks of unforeseen complications from including brief, isolated measurement requirements within IAS 32 (not linking to IFRS 9 or IFRS 13 where detailed application guidance is provided).

    c) These instruments often include variability, for example, from being linked to an EBITDA multiple. This could lead to measurement issues as the proposed clarifications do not seem to address such variability. Possible solutions would be to use fair value, to apply a 'higher of' approach or to mirror the concept of demand deposit in IFRS 13.

    d) The proposal could have unintended consequences, and FIWG members would need to consider the precise wording in the exposure draft.

    e) One FIWG member further commented on risks when the amount recognised was greater than the cash received. In the UK context that could give rise to questions on whether that was a deemed distribution and on the impact on distributable profits.

[6] See IFRS 17.B102.

[7] See July 2022 IASB staff paper AP5 for background and July 2022 IASB staff paper AP5A for practice questions; the September 2022 decisions and September 2022 staff paper AP5; and February 2023 staff paper 5B and the February 2023 decisions.

## Contingent settlement provisions

27. A paper had been provided to FIWG members summarising the IASB's tentative decisions on contingent settlement provisions and setting out questions for members to consider. The UKEB Secretariat introduced the paper and the Chair invited views on the draft proposals[8].

28. The following points arose during the discussion:

    a) The scope of the requirements, and in particular, the distinction between these contingent features and those that affect only the timing of settlement of an existing liability (e.g. loans with covenants), did not appear clear.

    b) One FIWG member considered that if an amount became payable because a covenant was breached, then that was a contingent event. It was challenging to distinguish breaches of covenants from other contingent events.

    c) In relation to measurement, members emphasised that the interaction between IFRS 9 and IAS 32 needed to be clearer. In particular, FIWG members found the guidance on measuring the equity residual unclear, particularly in the absence of references to IFRS 9 and IFRS 13.

    d) One FIWG member considered that the proposed changes could lead to inconsistent accounting, depending on how contracts were written.

    e) Another FIWG member considered that a requirement that contingent settlement provisions should be treated as if they were payable on demand may be more workable, because it would lead to accounting under IFRS 9/IFRS 13. However, another FIWG member cautioned that debate still arises on how to account for a demand feature.

29. FIWG members were asked for their thoughts on the definitions of "liquidation" and "non-genuine". FIWG members were unclear why the existing wording was regarded as insufficient. One FIWG member expressed concerns with the IASB staff's conclusion that a regulatory change clause could not be regarded as non-genuine.

30. Overall, for each of the FICE topics discussed above, it would be important to see the actual wording in the exposure draft to clearly understand the implications for current practice. Given current diversity in practice the proposals are expected to

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8 See December 2021 Board Papers: Agenda Paper 5A Contingent settlement provisions: compound financial instruments; Agenda Paper 5B Contingent settlement provisions: the meaning of 'liquidation' and 'non-genuine' and February 2023 Agenda Paper 5B Classification and presentation: Sweep Issues (Part B).

result in change for some entities, as a result, a key aspect to assess would be the transitional provisions in the Exposure Draft.

## AOB

31. The IASB staff presentation on Dynamic Risk Management was confirmed on the agenda for November 2023.

32. The January FIWG meeting would take place on 16th January 2024.

33. FIWG members noted that questions on power purchase agreements were beginning to come through to the accounting firms' technical teams, and there was increasing interest in this subject.

34. The Secretariat would welcome input on the elements of the IASB's Annual Improvements project that related to IFRS 9.

35. The FIWG was informed of the UKEB open consultation regarding the amendments relating to supplier finance arrangements. The UKEB comment deadline is 18th October 2023.