Staff paper

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IASB® meeting

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Project	**Amendments to classification and measurement of financial instruments**
Topic	**Accounting policy choice for derecognition of financial liabilities**
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Introduction

1. In October 2022 the IASB considered possible standard-setting options to respond to concerns raised about the potential outcomes of applying the derecognition requirements in IFRS 9 to the settlement of a financial asset or a financial liability via electronic cash transfers. The IASB tentatively decided to develop an accounting policy choice to allow an entity to derecognise a financial liability before it delivers cash on the settlement date when specified criteria are met.

2. The purpose of this paper is to further develop the criteria and scope of such an accounting policy choice, taking into account the comments and questions from IASB members during the that meeting.

3. This paper is structured as follows:

   (a) summary of staff recommendations and question for the IASB;

   (b) a reminder of the discussions to date;

   (c) the proposed criteria for derecognising a financial liability before settlement date; and

   (d) the scope of the proposed accounting policy choice.

Summary of staff recommendations and question for the IASB

4. To improve the consistent application of the requirements in IFRS 9, we recommend clarifying that an entity applies settlement date accounting when recognising and derecognising financial assets (except for regular way transactions) and financial liabilities.

5. With regards to the accounting alternative for derecognising a financial liability before settlement date, we recommend refining the criteria to require:

   (a) an entity to have no ability to withdraw, stop or cancel an electronic payment instruction;

(b) the entity to have lost the practical ability to access the cash as a result of the electronic payment instruction; and

(c) the settlement risk associated with the electronic payment instruction to be insignificant. For this to be the case, the payment system used must have the following characteristics:

    (i) the period between the payment initiation date and settlement date is relatively short and is standardised for the particular payment system concerned; and

    (ii) completion of the payment instruction follows a standard administrative process so that the debtor has reasonable assurance that the transfer will be completed, and the cash will be delivered to the creditor.

6. We also continue to be of the opinion that the scope of an accounting alternative must be deliberately limited to particular types of transactions such as electronic payment systems that meet the specified criteria without otherwise changing the general derecognition requirements in IFRS 9.

Question for the IASB

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Do you agree with the staff recommendations as set out in paragraphs 4 to 6 of this paper?

Reminder of the discussions to date

7. As noted in paragraph 16 of Agenda paper 3C for the October 2022 meeting, paragraph 3.1.1 of IFRS 9 requires a financial instrument to be recognised when the entity becomes a party to the contractual provisions of the instrument. Paragraph B3.1.2 then provides examples of how this principle is applied, including:

    (a) unconditional receivables and payables, which are recognised when an entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash; and

    (b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services, which are generally not recognised until at least one of the parties has performed under the contract.

8. Paragraph B3.1.3 of IFRS 9, states that a regular way purchase or sale of financial assets is recognised using either trade date or settlement date accounting.

9. In the tentative agenda decision *Cash Received via Electronic Transfer as Settlement for a Financial Asset* (IFRS 9) (published in September 2021) and discussions on the matter, the Interpretations Committee (the Committee) observed that settlement of a receivable is not a purchase or sale of a financial asset and therefore not a regular way transaction. This is because Appendix A of IFRS 9 defines a regular way purchase or sale as:

> A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned

10. In other words, regular way transactions give rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative.[1]

11. As the choice between trade date and settlement date accounting is only available to regular way transactions, for the recognition and derecognition of all other financial assets and liabilities, settlement date accounting is required.

12. Settlement date accounting is described in paragraph B3.1.6 of IFRS 9 as the date an asset is delivered to or by the entity. Settlement date therefore refers to (a) the recognition of an asset on the day the entity receives it; and (b) the derecognition of an asset (and recognition of any related gain or loss on disposal) on the day the entity delivers it. The same principle applies to recognition or derecognition of financial liabilities.

13. Although the requirement to apply settlement date accounting when recognising and derecognising financial assets (except for regular way transactions) and financial liabilities has been carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*, the comments on the Committee's tentative agenda decision and outreach we've done, indicate that there is a widespread diversity in practice. Therefore, to improve consistent application of the requirements, we recommend clarify this in IFRS 9.

Proposed criteria for derecognising a financial liability before settlement date

14. In its October 2022 meeting, the IASB tentatively decided to develop an accounting policy choice to permit an entity to derecognise a financial liability before it delivers cash on the

[1] Paragraph BA.4 of IFRS 9

settlement date when specified criteria are met. Similar to regular way transactions, this would be an accounting alternative to the settlement date requirements in IFRS 9 and will provide entities with the choice to derecognise a financial liability either on settlement date or before settlement date if the specified criteria are met.

15. While we continue to agree that the settlement of a receivable or payable is not a regular way transaction, we think there are characteristics of regular way transaction accounting that could be helpful in developing the proposed accounting alternative, including:

    (a) regular way transaction accounting is an alternative to the general requirements regarding the date on which financial assets are recognised or derecognised, in the form of a choice between trade date or settlement date;

    (b) this choice is only available to particular types of transactions that have specified characteristics and is applied consistently to all similar transactions;

    (c) the period between trade date and settlement date is relatively short and is established generally by regulation or convention in the marketplace concerned;

    (d) application of trade date accounting bears relatively low settlement risk (ie the risk that either the security or the cash fails to be delivered on settlement date) and completion of the transaction is largely an administrative process.

16. We considered the requirements in paragraph AG38F of IAS 32 which sets out the characteristics of a gross settlement system that would meet the net settlement criterion in paragraph 42(b) of IAS 32. To clarify the principle behind net settlement, the IASB described the characteristics of a gross settlement system that eliminates or result in insignificant credit and liquidity risk and processes receivables and payables in a single settlement process or cycle that is equivalent to net settlement, for example:

    (a) once the financial assets and financial liabilities are submitted for processing, the parties are committed to fulfil the settlement obligation; and

    (b) there is no potential for the cash flows arising from the assets and liabilities submitted for processing to change once they have been submitted.

17. For both regular way transactions in IFRS 9 and particular gross settlement systems in IAS 32, one of the key principles is that the risk of settlement not occurring is insignificant.

18. In Agenda paper 3C for the October 2022 IASB meeting, the staff proposed potential criteria for the proposed accounting alternative to be applied, being:

(a) the entity is irrevocably committed to the cash payment and therefore has effectively lost control of the cash;

(b) the initiation and completion of the cash transfer takes place within a short timeframe as established by market convention for such electronic payments; and

(c) completion of the cash transfer is subject only to an administrative process and not settlement risk of the entity.

19. We think it is important to remember why these criteria are considered–to develop an accounting alternative for derecognising a financial liability before settlement date. Consistent with the requirements for settlement date accounting in paragraph B3.1.6, paragraph B3.3.1 of IFRS 9 states that a financial liability is extinguished when the debtor either:

(a) discharges the liability by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability either by process of law by the creditor.

20. In other words, the proposed accounting alternative is aimed at describing circumstances that are equivalent to a creditor discharging a liability by paying the creditor with cash. In response to questions and comments from IASB members and other stakeholders, we are recommending refinements as set out in paragraphs 21–31 below.

Irrevocably committed to the cash payment

21. Typically, entities facilitate most cash payments to settle its financial liabilities by issuing payment instructions to an entity's bank. The bank then processes these payments as instructed by entity, subject to there being sufficient available funds in the entity's account to cover the payment. Payment instructions can be made in various forms, for example using electronic transfer systems such as Bacs or CHAPS, cheques or online payments. We will call this 'the payment initiation date' of the payment for the purpose of this paper.

22. Although an entity might be committed to settle the liability on the payment initiation date, depending on the payment method used, the entity might still be able to withdraw, stop or cancel the payment instruction and therefore the entity is not irrevocably committed to the payment.

23. This could be the case in many payment methods, including some electronic transfer systems. Therefore, we proposed an entity being irrevocably committed to making the cash payment as

one of the criteria for a possible accounting alternative because if an entity could withdraw its payment instruction, it could not be said that the entity has discharged the liability as required by paragraph B3.3.1(a) in IFRS 9.

24. However, requested by some IASB members, we recommend being clearer about what is meant with being 'irrevocably committed to making a payment' by further refining this criterion to require an entity to not have the ability to withdraw, stop or cancel a payment instruction.

Lost control over the cash

25. Paragraph 40 of Agenda paper 3C for the October 2022 meeting described particular circumstances in which an entity can no longer withdraw its payment instruction and as a result, the cash is no longer available for other use by the entity (even though it might still be in the entity's account). At this point, the entity might be reasonably certain that the cash will be delivered to the counterparty in accordance with the standard processing time for the specific cash payment system used (which is usually within a short timeframe). In other words, the entity has effectively lost 'control' over the cash

26. The staff's reasoning was that if an entity has the ability to withdraw a payment instruction, it has not lost the ability to direct the use of the cash for a purpose other than settling the financial liability. And therefore, it could neither be considered that cash has been delivered by the entity (as required by paragraph B3.1.6 of IFRS 9) nor that the entity has paid the creditor with cash (as required by paragraph B3.3.1(a) of IFRS 9).

27. When referring to an entity effectively having lost control over the cash, the staff had in mind situations where an entity has lost the practical ability to access that amount of cash even though the cash has not left the entity's account yet. For example, the cash might still be included in the entity's cash balance with the bank, but the available balance has been reduced by the amount of the payment transaction, and the transaction is shown as 'pending' or 'on hold'.

28. The practical ability to access this specific amount of cash referred to in the payment instruction, will be lost when the entity cannot withdraw, stop or cancel the payment instruction. In other words, the entity cannot prevent the payment from being completed. This point will depend on the payment method used (for example cheques are typically cancellable for a longer period than some electronic cash transfers). However, this also means that the entity's ability to access that amount of cash or directs it use for a purpose other than settling the payment obligation, is lost before completion of the payment, that is before cash is delivered to the creditor on settlement date.

29. We acknowledge that control per se is not generally used when determining whether a financial instrument is recognised or derecognised and the potential risk for unintended consequences that could arise from using it as a criterion in this instance. Therefore, following feedback from some IASB members during the October 2022 meeting, the staff recommends referring to an entity no longer having the practical ability to access the cash rather than no longer having control of the cash.

Necessary characteristics of the payment method to minimise settlement risk

30. Applying the derecognition requirements as set out in paragraphs B3.1.6 and B3.3.1 of IFRS 9, the creditor is not exposed to any settlement risk associated with the payment.

31. Settlement risk refers to the risk that the asset will be not delivered by the debtor on the settlement date. Therefore, consistent with what we described in paragraph 17 of this paper, for any potential accounting alternative to derecognise a financial liability before the settlement date, the risk of the settlement not occurring must be insignificant. For this to be the case the payment method used for settling the obligation must have the following characteristics:

    (a) the period between the payment initiation date and settlement date is relatively short and is standardised for the particular payment method concerned. The longer the standard processing time for a particular payment method the higher the risk that the payment may not be completed due to default of the debtor; and

    (b) completion of the payment instruction follows a standard administrative process so that the debtor has reasonable assurance that the transfer will be completed and the cash will be delivered to the creditor.

Scope of an accounting policy choice

32. In its October 2022 meeting, some IASB members asked the staff to consider whether the scope of the proposed accounting alternative could be applied to a wider populations of cash payments rather than being limited to electronic cash payment systems. Specific requests included the accounting alternative to be available to all cash disbursements out of demand deposits held with a financial institution or being available as a general principle in IFRS 9 that would also apply to cash receipts for settlement of financial assets.

All cash disbursements out of demand deposits

33. The staff foresees a number of challenges with such an approach. In our view, this would mean the accounting alternative would not only apply to all payment methods (such as cheque

payments or electronic transfers), but it would also exclude any cash payments made out of other accounts an entity might have with a bank such as an overdraft. The practical challenges that led to the IASB tentatively deciding to develop an accounting alternative, did not arise from the nature of the account from which payment instructions are being made from, but rather from the nature of the payment method being used.

34. Furthermore, creating an accounting alternative for all cash payments in general carries the risk that cash is seen to be treated differently as other financial assets for the purposes of the derecognition requirements in IFRS 9, thereby leading to different accounting outcomes when an entity is settling a transaction with cash compared to delivering another financial asset on settlement date, for example a security.

35. In our view, such an approach would not result in a narrow-scope accounting alternative, but require a fundamental change to the derecognition requirements in IFRS 9 and be subject to the considerations discussed in paragraph 30 of Agenda paper 3C of the October 2022 meeting. Therefore, such an approach would require significant time and resource investment, both internally and externally and could not be completed in a timely manner.

36. We believe meeting the objectives of this narrow-scope standard-setting project can be best achieved when limiting the accounting alternative to electronic cash transfers using an electronic payment system.

Settlement of financial assets

37. As noted in Agenda paper 12A for the September 2022 IASB meeting, although the submission to the Committee described and asked about a fact pattern involving the settlement of a receivable via an electronic payment system, most of the comments received on the tentative agenda decision raised concerns about the potential outcomes for settlement of liabilities. Most of the comments made in the context of receivables were related to the classification of receivables as 'cash in-transit' or cash equivalents. These questions are outside the scope of IFRS 9 and therefore not relevant to the proposed accounting alternative.

38. Furthermore, we believe the same considerations as discussed in paragraph 34 and 35 would apply to the settlement of receivables. We are also of the view that the proposed criteria and refinements recommended by the staff in paragraph 5 of this paper could not apply to receivables and therefore there would be no benefit in including receivables in the scope of the proposed accounting alternative.

Conclusion

39. In contrast to a wider scope application of the accounting alternative, we are of the opinion that limiting the narrow-scope amendment to electronic cash transfers using an electronic payment system would:

    (a) be operable as the scope of such amendment would sufficiently narrow and limited to specified circumstances;

    (b) mitigate the risk of unintended consequences by referring to appropriate criteria to be met; and

    (c) not significantly reduce the usefulness of the information that would result from the consistent application of these requirements. However, such an approach would not necessarily reduce the costs of applying the derecognition requirements for all entities because the accounting policy choice would be available only when specified criteria are met.

    (d) reduce, where possible, the costs of applying the general derecognition requirements in IFRS 9—including costs for entities that would have to change their current practices to comply with these requirements; and

    (e) allow entities whose accounting practices are already compliant with the current requirements of IFRS 9 to continue with these practices.

40. As a consequence, we continue to be of the opinion that the scope of an accounting alternative must be deliberately limited to particular types of transactions such as electronic payment systems that meet the specified criteria without otherwise changing the application of the general derecognition requirements in IFRS 9.