iGAAP in Focus

Financial reporting

IASB issues amendments to the classification and measurement requirements of financial instruments

Contents

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This *iGAAP in Focus outlines Amendments to the Classification and Measurement of Financial Instruments,* which amend IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures* and was published by the International Accounting Standards Board (IASB) in May 2024.

- The IASB published amendments to IFRS 9 that address the following topics:
  - derecognition of a financial liability settled through electronic transfer
  - classification of financial assets—contractual terms that are consistent with a basic lending arrangement
  - classification of financial assets—financial assets with non-recourse features
  - classification of financial assets—contractually linked instruments
- The IASB also published the following amendments to IFRS 7:
  - disclosures—investments in equity instruments designated at fair value through other comprehensive income
  - disclosures—contractual terms that could change the timing or amount of contractual cash flows on the occurrence (or non-occurrence) of a contingent event
- The need for these amendments was identified as a result of the IASB's post-implementation review of the classification and measurement requirements of IFRS 9
- The amendments are effective for annual reporting periods beginning on or after 1 January 2026 with earlier application permitted
- An entity is required to apply the amendments retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, unless specified otherwise. An entity is not required to restate prior periods.

Background

In 2022, the IASB concluded its post-implementation review of the classification and measurement requirements of IFRS 9. In general, the IASB found that preparers can apply the requirements consistently. However, the IASB identified matters that require amendments to IFRS 9 and IFRS 7. In March 2023, the IASB proposed these amendments in an exposure draft (ED) titled *Amendments to the Classification and Measurement of Financial Instruments—Proposed amendments to IFRS 9 and IFRS 7.* The IASB subsequently deliberated the feedback received in response to the ED and decided to finalise the amendments.

Amendments to IFRS 9

Derecognition of a financial liability settled through electronic transfer

The application guidance in IFRS 9 is amended to clarify the date of initial recognition or derecognition of financial assets and financial liabilities.

The existing application guidance states that a financial liability is derecognised at its settlement date, being the date on which the liability is extinguished because the obligation specified in the contract is discharged, cancelled or expires, or the liability otherwise qualifies for derecognition. As an alternative to this requirement, the amendments permit an entity to deem a financial liability (or part of it) that will be settled in cash using an electronic payment system to be discharged before the settlement date if, and only if, the entity has initiated a payment instruction that has resulted in:

- the entity having no practical ability to withdraw, stop or cancel the payment instruction
- the entity having no practical ability to access the cash to be used for settlement as a result of the payment instruction
- the settlement risk associated with the electronic payment system being insignificant.

'Settlement risk' generally refers to the risk that a transaction will not be settled (or completed) and therefore that a debtor will not deliver cash to a creditor on the settlement date. For the purposes of the requirements in 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.

Settlement risk associated with an electronic payment system is insignificant if its characteristics are such that completion of the payment instruction follows a standard administrative process and the time between the first two criteria above being met and the cash being delivered to the counterparty is short. However, settlement risk is not insignificant if completion of the payment instruction is subject to the entity's ability to deliver cash on the settlement date.

An entity that elects to apply the derecognition alternative for financial liabilities is required to apply it to all settlements made through the same electronic payment system.

Observation

The application of IFRS 9 to the derecognition of a financial asset settled via an electronic transfer was brought to the attention of the IFRS Interpretations Committee (IFRS IC) in September 2021. At the time, the IFRS IC tentatively concluded that an entity is required:

- to derecognise a trade receivable on the date on which its contractual rights to the cash flows from the trade receivable expire
- to recognise the cash (or other financial asset) received as settlement of that trade receivable on the same date.

The agenda decision was not finalised because of concerns raised about the potential outcomes of the tentative conclusion. Instead, these concerns were referred to the IASB.

In response, the IASB considered amending IFRS 9 to clarify when the contractual rights to the cash flows from a financial asset expire or when a financial liability is extinguished. However, stakeholders of the IASB noted that determining exactly when a liability is extinguished, or the rights to the cash flows from a financial asset expire, could be time-consuming, costly and involve extensive (legal) analysis of each payment platform and the related individual contractual terms. This is because the relevant regulations and requirements to determine the point of extinguishment vary between jurisdictions and could potentially lead to economically similar financial assets and financial liabilities being derecognised at different times.

The IASB therefore decided not to fundamentally reconsider the recognition and derecognition requirements in IFRS 9 and to issue the narrow-scope amendments set out above instead.

Observation

As part of the IASB's deliberations, the IASB concluded that the alternative treatment for derecognition of financial liabilities should not be made available for financial assets. In the IASB's view, there is no equivalent notion of having 'no practical ability to withdraw, stop or cancel the payment instruction' for financial assets as the recipient of cash does have those rights. The IASB also noted that when a debtor initiates a payment instruction through an electronic payment system (and the debtor has no practical ability to withdraw the instruction), the debtor loses the practical ability to access (i.e. use) the cash during the time before the cash is delivered. However, the counterparty (i.e. the creditor) does not have the practical ability to access the cash upon notification of the payment instruction; access to the cash only occurs when the cash is delivered to the creditor's account.

Classification of financial assets

Contractual terms that are consistent with a basic lending arrangement

The application guidance in IFRS 9 is amended to provide guidance on how an entity assesses whether contractual cash flows of a financial asset are consistent with a basic lending arrangement. This is intended to assist an entity to apply the requirements for assessing contractual cash flow characteristics to financial assets with features linked to environmental, social and governance (ESG) concerns.

The IASB specifies that when assessing interest, an entity focuses on *what* an entity is being compensated for, rather than *how much* compensation it receives. Nonetheless, the amount of compensation an entity receives may indicate that the entity is being compensated for something other than basic lending risks and costs.

The amendments clarify that contractual cash flows are inconsistent with a basic lending arrangement if they are indexed to a variable that is not a basic lending risk or cost (for example, the value of equity instruments or the price of a commodity) or if they represent a share of the debtor's revenue or profit, even if such contractual terms are common in the market in which the entity operates.

In some cases, a contingent feature gives rise to contractual cash flows that are consistent with a basic lending arrangement both before and after the change in contractual cash flows, but the nature of the contingent event itself does not relate directly to changes in basic lending risks or costs. For example, the terms of a loan may specify that the interest rate is adjusted by a specified amount if the debtor achieves a contractually specified reduction in carbon emissions. In such a case, the financial asset has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if, and only if, in *all* contractually possible scenarios, the contractual cash flows would not be significantly different from the contractual cash flows on a financial instrument with identical contractual terms, but without such a contingent feature. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment; but, in other circumstances, it may be necessary to perform a quantitative assessment. If it is clear, with little or no analysis, that the contractual cash flows are not significantly different, an entity need not perform a detailed assessment.

Observation

The IASB considered whether this assessment should be based on cash flows that are 'not significantly different', or 'not more than insignificantly different'. The IASB noted feedback on the modified time value of money element that 'more than insignificant' could be unduly restrictive. Consistent with the assessment of interest focusing on what an entity is being compensated for, rather than how much compensation it receives, the IASB decided that a threshold of 'not more than insignificantly different' would again unduly emphasise 'how much' compensation an entity receives.

The IASB also confirmed that the assessment of the contractual cash flows takes into consideration all contractual cash flows that could arise over the life of the instrument, i.e. an entity considers the effect of a contingent event on the contractual cash flows, however likely or unlikely the event is to occur (unless the contractual terms are not genuine).

In order to illustrate the above, the IASB added to the application guidance in IFRS 9 the following two examples of financial assets that have, or do not have, contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Example 1:

Instrument EA is a loan with an interest rate that is adjusted every reporting period by a fixed number of basis points if the debtor achieves a contractually specified reduction in carbon emissions during the preceding reporting period. The maximum possible cumulative adjustments would not significantly change the interest rate on the loan.

In this case, the entity considers whether the contractual cash flows that could arise both before and after each change in contractual cash flows are solely payments of principal and interest.

If the contingent event of achieving the carbon emissions target occurs, the interest rate is adjusted by a fixed number of basis points, resulting in contractual cash flows that are consistent with a basic lending arrangement. It is only because the nature of the contingent event itself does not relate directly to changes in basic lending risks and costs that the entity cannot conclude—without further assessment—whether the cash flows on the financial asset are solely payments of principal and interest.

The entity therefore assesses whether, in all contractually possible scenarios, the contractual cash flows would not be significantly different from the contractual cash flows on a financial instrument with identical contractual terms, but without the contingent feature linked to carbon emissions.

Because any adjustments over the life of the instrument would not result in contractual cash flows that are significantly different, the entity concludes that the loan has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Example 2:
Instrument I is a loan with an interest rate that is adjusted every reporting period to track the movements in a market-determined carbon price index during the preceding reporting period.

The contractual cash flows are indexed to a variable (the carbon price index), which is not a basic lending risk or cost. The contractual cash flows are therefore inconsistent with a basic lending arrangement.

Observation
The IASB found that the contractual cash flow characteristics assessment in IFRS 9 is as relevant to financial assets with ESG-linked features as it is to other financial assets, and that the amended requirements in IFRS 9 provide an appropriate basis to determine whether such financial assets meet the conditions to be measured at amortised cost or at fair value through other comprehensive income (FVTOCI).

The IASB therefore concluded that creating an exception from the requirements on contractual cash flow characteristics in IFRS 9 for financial assets with ESG-linked features would not be appropriate.

Financial assets with non-recourse features
IFRS 9 is amended to enhance the description of the term 'non-recourse'. Under the amendments, a financial asset has non-recourse features if an entity's ultimate right to receive cash flows is contractually limited to the cash flows generated by specified assets. In other words, the entity is primarily exposed to the specified assets' performance risk rather than the debtor's credit risk. For example, a creditor's ultimate right to receive cash flows may be contractually limited to the cash flows generated by specified assets of a structured entity.

Contractually linked instruments
The amendments clarify the characteristics of contractually linked instruments that distinguish them from other transactions. Specifically, the amendments highlight that in such instruments a prioritisation of payments to the holders of financial assets using multiple contractually linked instruments (tranches) is established through a waterfall payment structure, resulting in concentrations of credit risk and a disproportionate allocation of losses between the holders of different tranches.

The amendments also note that not all transactions with multiple debt instruments meet the criteria of transactions with multiple contractually linked instruments; some are instead lending arrangements that are structured to provide enhanced credit protection to a creditor (or group of creditors). For example, a structured entity may be set up to hold the underlying assets that will generate the cash flows to repay the creditor. The structured entity issues senior and junior debt instruments. The creditor holds the senior debt instrument and the entity sponsoring the structured entity that holds the junior debt instrument has no practical ability to sell the junior instrument without the senior debt instrument becoming payable. Under the amendments, the holders of such debt instruments apply the requirements for contractual cash flows that are solely payments of principal and interest on the principal amount outstanding instead of the contractually linked instruments requirements.

The contractually linked instruments requirements in IFRS 9 apply only if the underlying pool includes one or more instruments that have contractual cash flows that are solely payments of principal and interest. The amendments clarify that this includes financial instruments that are not within the scope of the classification requirements, provided these instruments have contractual cash flows that are equivalent to solely payments of principal and interest on the principal amount outstanding—for example, some lease receivables. The amendments specify that this would not be the case for lease receivables that are subject to residual value risk, or that comprise variable lease payments that are indexed to a variable that is not a basic lending risk or cost (for example, a market rental rate).

Amendments to IFRS 7

Investments in equity instruments designated at FVTOCI

The disclosures requirements in IFRS 7 in respect of investments in equity instruments designated at FVTOCI are amended. In particular, an entity is required to disclose the fair value gain or loss presented in OCI during the period, showing separately the fair value gain or loss that relates to investments derecognised in the period and the fair value gain or loss that relates to investments held at the end of the period. If an entity derecognises investments in equity instruments measured at FVTOCI during the reporting period, it is now required, under the amendments, to disclose any transfers of the cumulative gain or loss within equity during the reporting period related to the investments derecognised during that reporting period.

Also, an entity is no longer required to disclose the reporting date fair value of *each* equity instruments designated at FVTOCI, this information can be provided by class of instruments.

Contractual terms that could change the timing or amount of contractual cash flows

The amendments introduce disclosure requirements for financial instruments that include contractual terms that could change the timing or amount of contractual cash flows on the occurrence (or non-occurrence) of a contingent event that does not relate directly to changes in a basic lending risks and costs (such as the time value of money or credit risk). Disclosures include a qualitative description of the nature of the contingent event, quantitative information about the possible changes to contractual cash flows as well as the gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms. The entity is required to make these disclosures by class of financial assets measured at amortised cost or FVTOCI and by class of financial liabilities measured at amortised cost.

> **Observation**
> Although the IASB amended the classification of financial assets for financial instruments with cash flows that could change subject to a contingent event, and not the classification requirements for financial liabilities, the new disclosure requirements apply to both financial assets and financial liabilities. Consequently, an entity that *issues* a debt instrument where interest is, for example, linked to an ESG metric would be in the scope of the disclosure requirements, as would the investor of that instrument if that instrument meets the criteria for measurement at amortised cost or FVTOCI.

> **Observation**
> The IASB made the same amendments in respect of the disclosures required for financial instruments that include contractual terms that could change the timing or amount of contractual cash flows to IFRS 19 *Subsidiaries without Public Accountability: Disclosures* (the standard that limits the disclosure requirements for eligible subsidiaries).

Effective date and transition

The amendments are effective for annual reporting periods beginning on or after 1 January 2026. Earlier application is permitted.

If an entity elects to apply these amendments for an earlier period, it is required to either:

- apply all the amendments at the same time and disclose that fact or
- apply only the amendments to the classification of financial assets for that earlier period and disclose that fact.

> **Observation**
> One IASB member disagreed with the effective date of the amendments to IFRS 9 relating to the date of initial recognition or derecognition of financial assets or financial liabilities and, therefore, dissented from the issuance of the amendments. In his dissenting opinion, he stated that the proposed effective date of the amendments does not give entities sufficient time to apply the amendments, because in some instances, applying those requirements could necessitate widespread reporting system changes.

An entity is required to apply the amendments retrospectively, in accordance with IAS 8, except as specified below. For the purposes of the transition requirements, the date of initial application is the beginning of the annual reporting period in which the entity first applies the amendments.

An entity is not required to restate prior periods to reflect the application of the amendments. An entity may restate prior periods if, and only if, it is possible to do so without the use of hindsight. If an entity does not restate prior periods, it is required to recognise the effect of initially applying the amendments as an adjustment to the opening balance of financial assets and financial liabilities and the cumulative effect, if any, as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

At the date of initial application of the amendments to the classification of financial assets, an entity is required to disclose for each class of financial assets that changed measurement category as a result of applying the amendments:

- the measurement category and carrying amount determined immediately before the amendments were applied
- the measurement category and carrying amount determined immediately after the amendments were applied.

Further information

If you have any questions about the amendments to IFRS 9 and IFRS 7, please speak to your usual Deloitte contact or get in touch with a contact identified in this *iGAAP in Focus*.

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