Financial instruments developments

June 2023

Building a better working world

With you today

"In the current macro-economic climate, the correct accounting for and disclosure of financial instruments provides a vital narrative of how an entity manages its financial risk.

Cullum Allen
Partner
Financial Reporting Group
EY Inc.

"Almost every entity (regardless of industry) has financial instruments; therefore, it is essential for reporters to be aware of the proposed changes that will impact financial instrument accounting.

Andrea Koch
Associate Director
Financial Reporting Group
EY Inc.

Agenda

1 Topical issues

1.1 Accounting for Environmental, Social and Governance (ESG) loans

1.2 Settling financial liabilities using an electronic payment system

2 Challenges in applying IFRS 9 *Financial Instruments* principles

2.1 Classification and measurement

2.2 Expected credit loss (ECL) considerations

2.3 IFRS 7 *Financial Instruments*: *Disclosures* common disclosure pitfalls

3 Future developments

1 Topical issues

1.1

Accounting for Environmental, Social and Governance (ESG) loans

What is the difference between an ESG loan and a green loan?

Types of sustainability loans

Green loans

Loans granted to borrowers who operate in environmentally friendly sectors (e.g. a loan to a finance a solar plant) or loans that are granted to finance activities that are 'green'

ESG loans

Loans which have contingent rate adjustments that are linked to the attainment of an ESG feature (e.g. a loan whose interest rate will vary depending on carbon emissions of the borrower)

Key feature:
Contingent cash flows linked to ESG targets

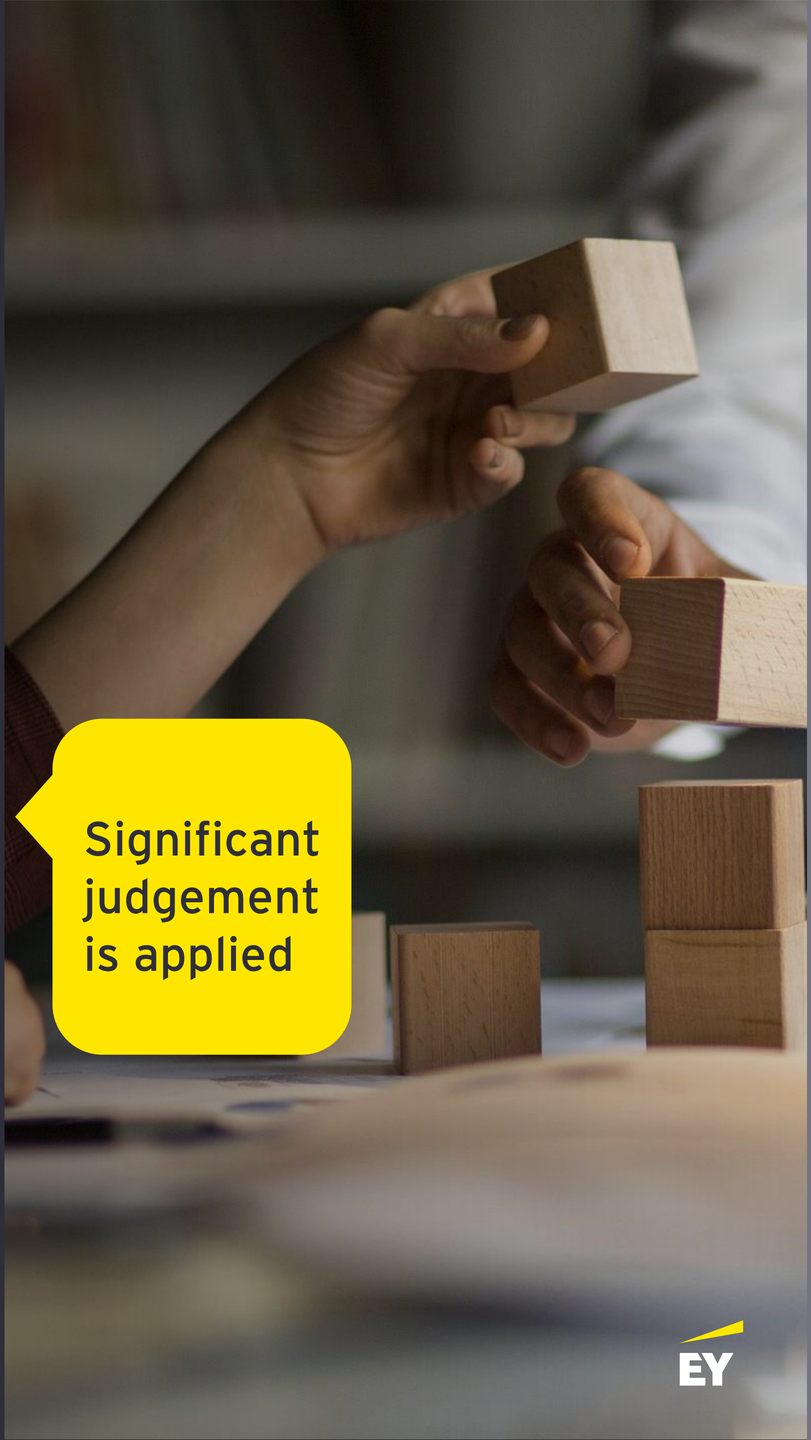
Key question:
Whether the holder of an ESG loan can measured it at amortised cost?

If not, it would need to be measured at fair value through profit or loss

Accounting for ESG loans: **Holder's** perspective example

- Currently, without the proposed amendments to IFRS 9, entities may have considered the following in assessing SPPI:

Compensation for credit risk	De minimis	Not compensation for non-basic lending risk
The attainment of the ESG target will improve the borrowers credit risk during the life of the loan	The impact of the ESG feature is trivial	The size and design of the ESG linked adjustments are often standardised and do not introduce compensation for specific ESG risk



Exposure draft: Amendments to IFRS 9 Classification of financial assets with ESG features

The International Accounting Standards Board (IASB) proposes two broad amendments:

Classification of financial assets

1 Basic lending arrangement

Inconsistent with basic lending arrangement if:

- Includes compensation not typically considered basic lending risks or costs; and
- The cash flow changes are not aligned with changes in lending risks or costs.

2 Contractual terms that change the timing or amount of the cashflows

- Assess if cash flows would meet SPPI irrespective of contingent event occurring;
- Contingent event should be specific to the debtor; and
- Not investment in the debtor or exposure to the performance of specified assets.

Accounting for ESG loans: **Holder's** perspective example

Fact pattern 1:

Instrument AB is a loan with an interest rate that is periodically adjusted by a specified number of basis points if the debtor achieves a contractually specified reduction in greenhouse gas emissions during the preceding reporting period.

Fact pattern 2:

Instrument XY is a loan with an interest rate that is periodically adjusted when a market-determined carbon price index reaches a contractually defined threshold.

Q **Do the loans above, with ESG features, meet the "solely payments of principal and interest" (SPPI) test?**

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Accounting for ESG loans: Holder's perspective example

Solution is based on proposed ED

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Fact pattern 1:

The contractual cash flows **are** solely payments of principal and interest on the principal amount outstanding.

The contractual cash flows represent neither an investment in the debtor nor an exposure to the performance of specified assets

The occurrence of the contingent event is specific to the debtor

The contractual cash flows arising from the occurrence (or non-occurrence) of the occurrence) of the contingent event are in all circumstances SPPI on the principal amount outstanding

Fact pattern 2:

The contractual cash flows are **not** solely payments of principal and interest on the principal amount outstanding.

The contractual cash flows change in response to a market factor which is not a basic lending risk or cost and is therefore inconsistent with a basic lending arrangement.

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Accounting for ESG loans: **Borrower's** perspective example

Q How would the above loan with ESG features be classified by the Group?

Financial liability under IFRS 9

Classified at amortised cost

Classified at FVTPL

If the ESG feature in the loan is not an embedded derivative, then the entire contract would be measured at amortised cost.

If the ESG feature in the loan is an embedded derivative, it should be separated from the loan and accounted for as a derivative (i.e. FVTPL (IFRS 9.4.3.3))

Periodic revisions of expectations of cash flows for the ESG feature may result in a catch up adjustment in profit or loss, for the recalculation of the amortised cost at the present value of the estimated contractual cash flows using the original effective interest rate (IFRS 9 B5.4.6)

Considering the definition of an embedded derivative - ESG features are often specific to the issuer

Derivative definition

IFRS 9 Appendices

A financial instrument or other contract within the scope of this Standard will all three of the following characteristics:

(a) Its value changes in response to the change in the specified interest rate, financial instrument price…., provided in the case of a non-financial variable that the variable **is not specific to a party to the contract (sometimes called the 'underlying')**

………

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Fact pattern 1:

Definition **not** met:
Measured at amortised cost entirely

Fact pattern 2:

Definition **met**:
ESG feature separately accounted for as a derivative

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1.2

Settling financial liabilities using an electronic payment system

Exposure draft: Amendments to IFRS 9 Settling financial liabilities using an electronic payment system

Q When should Entity A derecognise the financial liability?

T0

Entity A clicks "Pay" on the online banking system for balance owed to Entity B

T3

Payment clears in Entity A's bank account and Entity B's bank account reflects inflow

EY

Exposure draft: Amendments to IFRS 9 Settling financial liabilities using an electronic payment system

Settlement date accounting means the financial asset or financial liability is not derecognised until the cash has arrived in the recipient's bank account and is available for their use

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Apply settlement date accounting on derecognition of a financial asset

For a financial liability settled using an electronic payment system, an entity can make an accounting policy choice to derecognise the liability before settlement date

Made per electronic payment system

To be applied consistently for all payments using that electronic payment system

Exposure draft: Amendments to IFRS 9 Settling financial liabilities using an electronic payment system

The conditions for a financial liability to be derecognised before settlement date are as follows:

Policy choice to derecognise the liability before settlement date

- No ability to withdraw, stop or cancel
- No practical ability to access the cash
- Settlement risk is insignificant

If elected:
Apply to all financial liabilities settled using a particular electronic payment system

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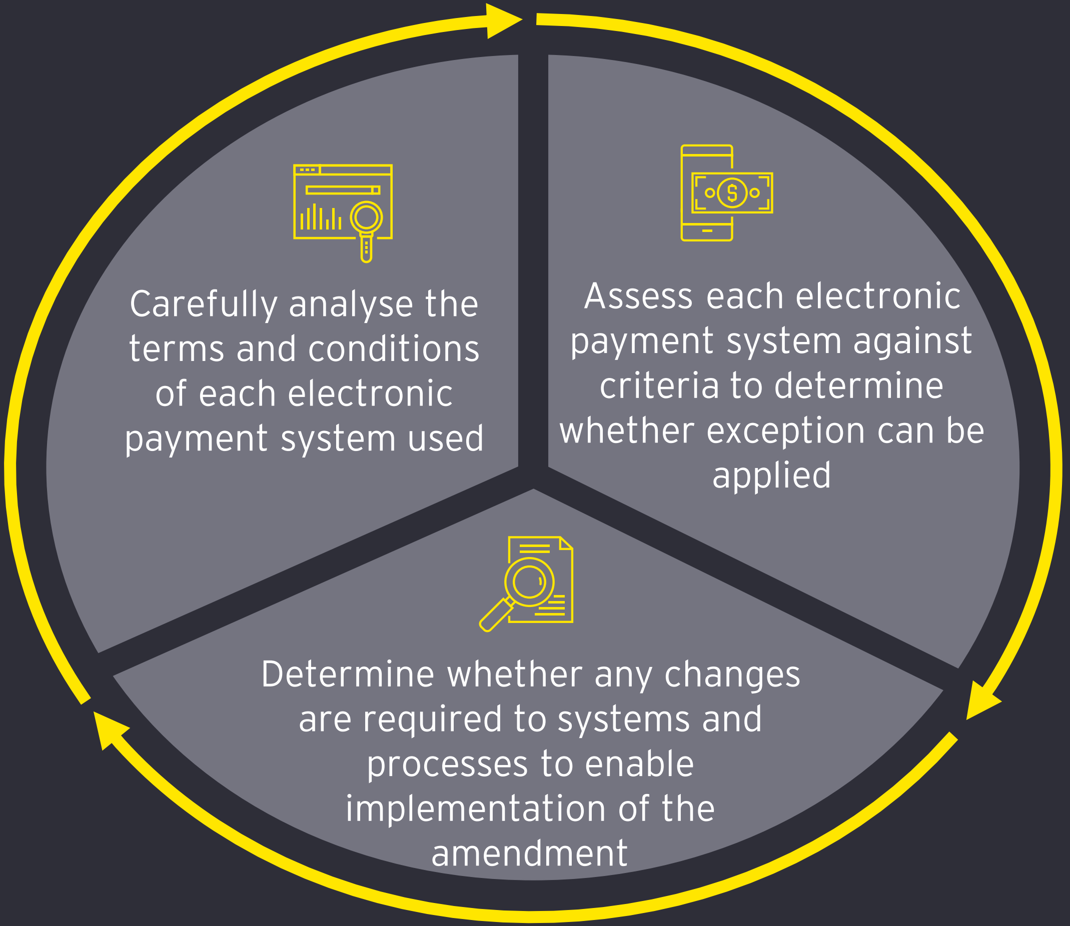
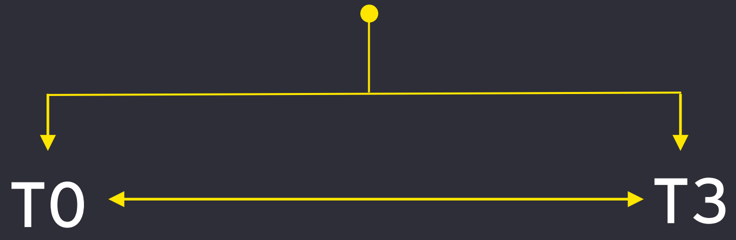
Practical implications of the proposed amendment

Entities will need to:





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Challenges in applying IFRS 9 *Financial Instruments* principles

2.1 Classification and measurement

Reclassification of financial assets

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In the fact pattern below, could the entity reclassify the financial assets from fair value through other comprehensive income to amortised cost?

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Fact pattern

- An entity owns a portfolio of liquid government bonds.
- The bonds were originally at fair value through other comprehensive income as the business model was to hold the bonds to collect contractual cash flows but also to sell them (mixed business model).
- Due to interest rates rising, the fair value of the bonds has declined and the company no longer intends on selling any of the bonds.
- The company wishes to reclassify these bonds to amortised cost.

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Reclassification of financial assets

Criteria for reclassifications of financial assets

IFRS 9.4.4.1	When, and only when, an entity changes its **business model** for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1 - 4.1.4
IFRS 9.B.4.4.1	Such changes are determined by the entity's senior management as a result of external or internal changes and must be **significant to the entity's operations and demonstrable to external parties.** Accordingly, a change in an entity's business model will occur only when an entity either **begins or ceases to perform an activity that is significant to its operations**
IFRS 9.B.4.4.3	The following are **not** changes in business model: (a) a **change in intention** related to particular financial assets (**even in circumstances of significant changes in market conditions**) (b) the temporary disappearance of a particular market for financial assets (c) a transfer of financial assets between parts of the entity with different business models

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Collective Investment Scheme (CIS) example

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Can the entity choose to measure the following at fair value through other comprehensive income (FVOCI)?

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Fact pattern

- An entity invests in units of a Collective Investment Scheme.
- The entity is holding the investment for long term strategic purposes and does not want to have profit and loss volatility due to changes in the value of the CIS.
- The units in the CIS are puttable – i.e., the investor can demand that the CIS repurchases its units at fair value.

Collective Investment Scheme (CIS) example

IFRS Interpretations Committee agenda decision Sep 2017

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Is the instrument a debt or equity instrument?

Debt

SPPI test (at instrument level)

Pass

Business model assessment (at aggregate level)

Fail

Fair value through profit or loss (FVTPL)

Because the returns follow the returns of equity instruments, the instrument fails the SPPI test

Because the SPPI test has failed, the instrument cannot be at FVOCI or amortised cost

Intercompany loans: Common challenges

- Lack of clarity of terms of the loan (inadequate documentation)
- Not identifying off-market elements or the substance of the loan
- Insufficient analysis of effect of modifications to the terms of a loan
- Inappropriate assessment of loans as either current/non-current
- Insufficient risk disclosure (credit, liquidity, interest rate)

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Intercompany loans: Initial measurement

Not a policy choice

IFRS 9 requires the initial recognition of financial assets and financial liabilities to be at **fair value** (except for certain trade receivables).

Interest-free or non-market interest rate loans

On demand

Generally, the fair value = the amount that can be demanded

Financial instruments arising from group transactions are initially recognised at their fair value, with any difference between the fair value and the terms of the agreement recognised as an **equity transaction**

Substance is one of a capital injection / distribution

FV = based on the market rate of interest for similar loans at the date of issue

Assume 'SPPI' test met = amortised cost for asset (parent's accounts) and amortised cost for liability (subsidiaries accounts)

Q How is an off-market loan accounted for in the separate financial statements of the parent and subsidiary?

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Intercompany loans example: Low interest

Substance: Capital contribution to subsidiary

Fact pattern

Assume Parent P provides Subsidiary S with a loan which at non-market related terms being that the interest charge is at a rate lower than that in the market, repayable over 5 years.

Parent	
Dr Financial asset [IFRS 9]	[Fair value]
Dr Investment in subsidiary	[Difference]
Cr Bank	[Cash value]
Dr Financial asset	
Cr Notional finance income	

Subsidiary	
Dr Bank	[Cash value]
Cr Financial liability [IFRS 9]	[Fair value]
Cr Equity contribution	[Difference]
Dr Notional finance cost	
Cr Financial liability	

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Intercompany loans example: Low interest

Substance: Distribution to parent

If the subsidiary advances a non-market loan to its parent, the difference between the loan amount and its fair value is treated as a **distribution by the subsidiary** to the parent, while the parent reflects a gain.

Interest is recognised on the loan and this has the effect that the initial fair value difference unwinds as the interest accrues on the loan.

1 — 2 — 3

Parent	
Dr Bank	[Cash #]
Cr Income/Gain	[Difference]
Cr Financial liability [IFRS 9]	[Fair value]
Dr Notional finance cost	
Cr Financial liability	

Subsidiary	
Dr Financial asset [IFRS 9]	[Fair value]
Dr Dividend distribution	[Difference]
Cr Bank	[Cash #]
Dr Financial asset	
Cr Notional finance income	

2.2

ECL considerations

Tracking credit risk under the simplified approach example

Fact pattern

- Company M, a furniture retailer, has a portfolio of trade receivables of CU30 million in 20X2
- These debtors contain a significant financing component
- Company M applies the simplified approach
- M uses a provision matrix to determine ECL's

Q

When applying the simplified approach, is there a need to track whether or not the trade debtors have become credit impaired?

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General vs. Simplified model

Simplified model

Lifetime ECL for all items

Required for:
- Trade receivables or contract assets with no significant financing component

Policy choice for:
- Trade receivables or contract assets, with significant financing component & lease receivables

General model

- **12-month ECL for items with no significant change in credit risk**
- **Lifetime ECL for items with significant change in credit risk**

Required for:
- All other assets in scope of ECL

Staging needs to be considered for all items in the general model – including intercompany receivables and investment debt instruments

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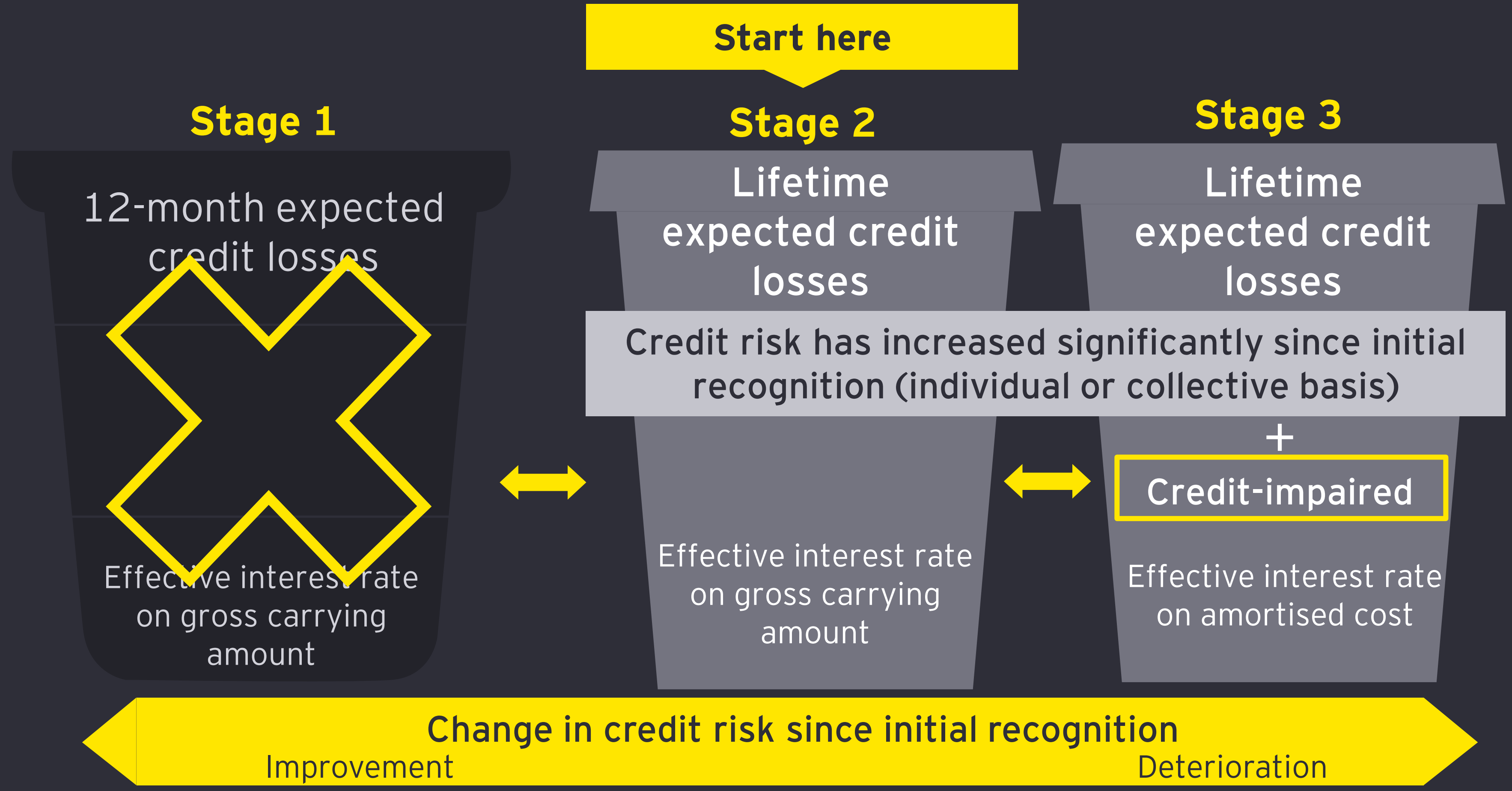
Tracking credit risk under the simplified approach

Two "buckets" still exist for simplified approach:

1. Not credit impaired (gross interest) and
2. Credit impaired (net interest)



Intercompany financial guarantee contracts example

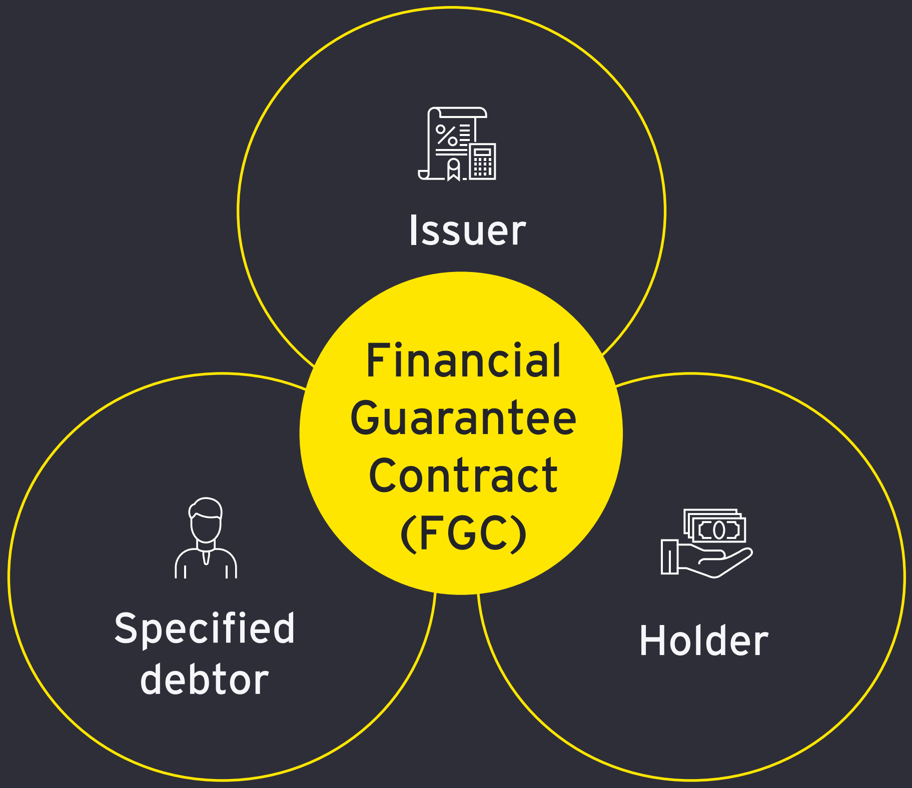
Q **How does the parent account for the financial guarantee contract in its separate financial statements?**

Fact pattern

- A group consists of two entities, H Ltd (the parent) and S Ltd (H's wholly owned subsidiary).
- Entity H has a stronger credit rating than S Ltd. S Ltd is looking to borrow CU 1,000, repayable in three years.
- A bank has indicated it will charge interest of 12% per annum. However, the bank has offered to lend S Ltd at a rate of 8% per annum if H Ltd provides a guarantee of S Ltd.'s debt to the bank.
- S Ltd chooses to borrow at 8% by obtaining H Ltd.'s guarantee
- H Ltd does not charge S Ltd for the guarantee.

Financial guarantee contracts

A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.



Accounting for financial guarantee contracts by the issuer

Insurance contract

OR

IFRS 9

- Initial recognition @fair value
- Subsequent measurement @higher of amortised premium and ECL

Intercompany financial guarantee contracts example Initial recognition - 1 January 2022

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- Entity H has a stronger credit rating than S Ltd.
- S Ltd is looking to borrow CU1 000, repayable in three years (bullet payment).
- A bank has indicated it will charge interest of 12% per annum. However, the bank has offered to lend S Ltd at a rate of 8% per annum if H plc provides a guarantee of S Ltd.'s debt to the bank.

Accounts of H plc	Debit	Credit
Investment in S Ltd (Statement of financial position (SoFP)) Financial guarantee liability (SoFP) Initial recognition of financial guarantee at fair value	FV	 FV

FGC is eliminated at a group level, because the liability is reflective of the full exposure

Various measurement methods
One method of measuring the fair value could be to use the difference between the guaranteed and unguaranteed lending rates that would be offered by the bank

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Intercompany financial guarantee contracts example Subsequent recognition - 31 December 2022

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- On 31 December 2022 there is a 1% probability of default in the next 12 months. There has been no significant increase in credit risk.
- Therefore the liability is adjusted to the higher of the ECL and the unamortised initial amount

Accounts of H plc
Profit or loss (P/L)
Financial guarantee liability (SoFP)
Subsequent accounting

The additional ECL on the FGC cannot be capitalised to the cost of the investment in subsidiary

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IFRS 7 credit risk disclosures			
Expected credit loss	Stage 1	Stage 2	Stage 3
Charge for the year	XX		

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2.3

IFRS 7 *Financial instruments: Disclosures* common disclosure pitfalls

IFRS 7 common disclosure pitfalls: Credit risk

ECL reconciliation:

Not detailed enough to provide useful information to the user – 1 line item for 'Movement during the year' (instead of disaggregating recoveries, write offs etc.)

The closing balance and P/L movement for ECL's not agreeing to other notes/balances

Inconsistencies in explaining movements in the gross carrying amount and the ECL balance

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Disclosing ECL assumptions under the simplified approach

Additional qualitative information should be provided to explain the changes in inputs to the ECL calculation

It is helpful to explain how forward looking information has been incorporated into the provision matrix - including the use of any management overlays

31 Dec 20X2 R'000	Current	0-30 days	31-60 days	61-90 days	>90 days	Total
Expected loss rate	0%	3%	8%	28%	70%	
Gross CA – Trade receivables	21 495	7 581	3 093	1 072	12 877	46 118
Impairment provision	(25)	(202)	(254)	(298)	(8 974)	(9 753)

31 Dec 20X1 R'000	Current	0-30 days	31-60 days	61-90 days	>90 days	Total
Expected loss rate	0%	0%	3%	3%	87%	
Gross CA – Trade receivables	31 125	6 479	567	424	5 153	49 748
Impairment provision	(4)	(11)	(19)	(14)	(4 499)	(4 547)

Higher loss rates in 20X2, despite reducing exposures

Explanation of data that goes beyond the expected trend

"The expected loss rate for the trade receivable overdue over 90 days as at 31 December 20X2 amounts to 70%, which is lower than the rate at 31 December 20X1, due to rent concessions granted in 20X1."

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IFRS 7 common disclosure pitfalls: Liquidity risk

★ No insight on how entity plans to manage liquidity constraints

★ Over-aggregation of time bands resulting in non-useful information (providing no more information than that available in the SoFP)

★ Information not relevant and specific to the entity's liquidity risk exposure

★ Insufficient information on how loan covenants/regulatory imposed requirements impact liquidity management (and whether or not there are adequate liquidity buffers)

Lease liabilities and loan commitments excluded from analysis

For issued FGCs, the maximum amount of the guarantee is not allocated to the earliest period in which the guarantee could be called

Derivative cash flows not shown gross where settlement will be gross

Maturity analysis not presented on an undiscounted basis

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Sample disclosure: Liquidity risk

Liquidity risk

The Group monitors its risk of a shortage of funds using a liquidity planning tool.

The Group's objective is to maintain a balance between continuity of funding and flexibility through the use of bank overdrafts, bank loans, debentures, preference shares, and lease contracts. The Group's policy is that not more than 25% of borrowings should mature in the next 12-month period. Approximately 10% of the Group's debt will mature in less than one year at 31 December 2022 (2021: 11%) based on the carrying value of borrowings reflected in the financial statements. The Group assessed the concentration of risk with respect to refinancing its debt and concluded it to be low. The Group has access to a sufficient variety of sources of funding and debt maturing within 12 months can be rolled over with existing lenders.

Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographical region, or have economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Group's performance to developments affecting a particular industry.

Internal liquidity ratios that are monitored

Entity specific

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Source: Good Group (International) Limited Illustrative consolidated financial statements for the year ended 31 December 2022 International GAAP®

Sample disclosure: Liquidity risk

The table below summarises the maturity profile of the Group's financial liabilities based on contractual undiscounted payments:

Year ended 31 December 2022	On demand €000	Less than 3 months €000	3 to 12 months €000	1 to 5 years €000	> 5 years €000	Total €000
Interest-bearing loans and borrowings (excluding items below)	966	–	1,422	10,554	8,000	20,942
Lease liabilities (Note 31)	48	117	290	2,454	1,473	4,382
Convertible preference shares	–	–	–	676	2,324	3,000
Contingent consideration	–	–	1,125	–	–	1,125
Other financial liabilities	–	–	–	150	–	150
Trade and other payables	3,620	12,547	802	–	–	16,969
Derivatives and embedded derivatives	1,970	2,740	391	1,191	1,329	7,621
	6,604	**15,404**	**4,030**	**15,025**	**13,126**	**54,189**

Year ended 31 December 2021	On demand €000	Less than 3 months €000	3 to 12 months €000	1 to 5 years €000	> 5 years €000	Total €000
Interest-bearing loans and borrowings (excluding items below)	2,650	–	76	8,872	11,600	23,198
Lease liabilities (Note 31)	32	90	296	2,386	1,432	4,236
Convertible preference shares	–	–	–	624	2,376	3,000
Trade and other payables	4,321	13,959	1,743	–	–	20,023
Other financial liabilities	–	–	–	202	–	202
Derivatives and embedded derivatives	549	1,255	–	–	–	1,804

Detailed time bands

SoFP aggregation

Undiscounted cash flows disclosed

Inclusion of lease liabilities

Gross values

Source: Good Group (International) Limited Illustrative consolidated financial statements for the year ended 31 December 2022 International GAAP®

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Future developments

Future developments

Financial instruments with characteristics of equity ('FICE') project	Dynamic risk management (macro-hedging)	IFRS Interpretations Committee: Accounting for PPA's

Exposure draft: Amendments to IFRS 9

- Classification of financial assets with ESG features
- Settling financial liabilities using an electronic payment system
- Changes for non-recourse loans and contractually linked instruments
- Additional disclosures for financial instruments with contingent features and for equity instruments classified at fair value through other comprehensive income

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'FICE' project

ED expected: Q4 2023

Background	Status of project
The IASB's FICE project seeks to address issues that arise in applying IAS 32 Financial Instruments: Presentation and to expand the disclosure requirements relating to issued financial instruments.	The IASB has now mostly completed its initial discussions, hence, we can anticipate many of the proposals that are likely to appear in its Exposure Draft (ED) on the subject.

Impact

- Fixed number of equity instruments for a fixed amount of cash/financial asset
- Obligations that arise only on liquidation of an entity
- The effect of laws
- Instruments with contingent settlement provisions
- Shareholder's discretion
- Reclassifications between debt and equity
- Obligations to redeem own equity instruments (e.g., put options on non-controlling interests)
- Presentation (including presentation for obligations that arise only on liquidation)
- Disclosures

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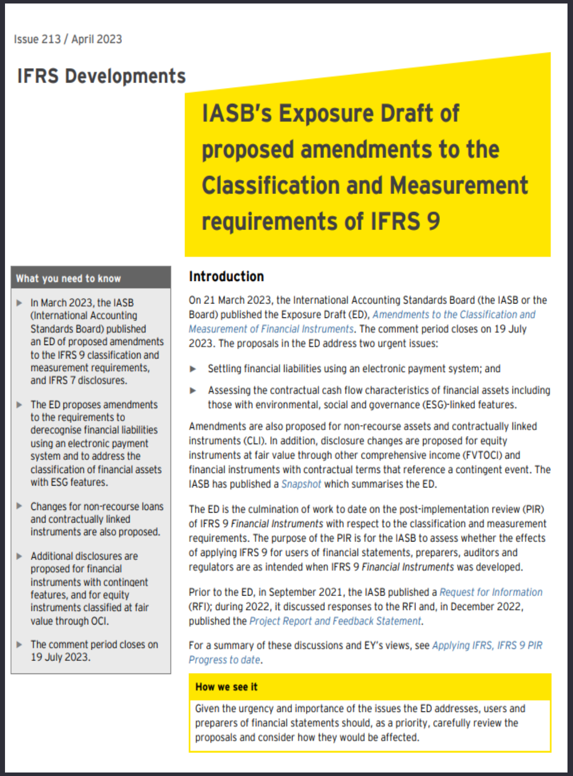
One minute recap

Resources

Available and free!
Link: EY Atlas Client Edition | EY - Global

[ePub version also available]

Resources


Issue 213 / April 2023

IFRS Developments

IASB's Exposure Draft of proposed amendments to the Classification and Measurement requirements of IFRS 9

What you need to know

- In March 2023, the IASB (International Accounting Standards Board) published an ED of proposed amendments to the IFRS 9 classification and measurement requirements, and IFRS 7 disclosures.
- The ED proposes amendments to the requirements to derecognise financial liabilities using an electronic payment system and to address the classification of financial assets with ESG features.
- Changes for non-recourse loans and contractually linked instruments are also proposed.
- Additional disclosures are proposed for financial instruments with contingent features, and for equity instruments classified at fair value through OCI.
- The comment period closes on 19 July 2023.

Introduction

On 21 March 2023, the International Accounting Standards Board (the IASB or the Board) published the Exposure Draft (ED), *Amendments to the Classification and Measurement of Financial Instruments*. The comment period closes on 19 July 2023. The proposals in the ED address two urgent issues:

- Settling financial liabilities using an electronic payment system; and
- Assessing the contractual cash flow characteristics of financial assets including those with environmental, social and governance (ESG)-linked features.

Amendments are also proposed for non-recourse assets and contractually linked instruments (CLI). In addition, disclosure changes are proposed for equity instruments at fair value through other comprehensive income (FVTOCI) and financial instruments with contractual terms that reference a contingent event. The IASB has published a *Snapshot* which summarises the ED.

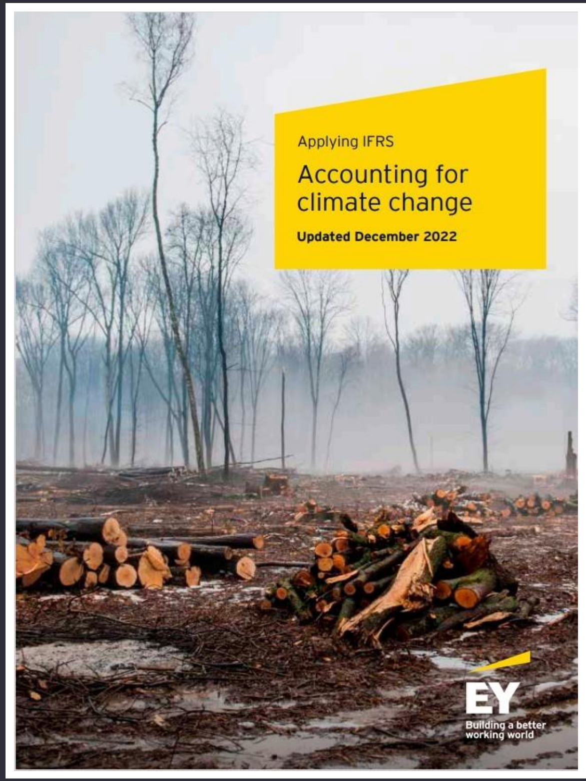
The ED is the culmination of work to date on the post-implementation review (PIR) of IFRS 9 *Financial Instruments* with respect to the classification and measurement requirements. The purpose of the PIR is for the IASB to assess whether the effects of applying IFRS 9 for users of financial statements, preparers, auditors and regulators are as intended when IFRS 9 *Financial Instruments* was developed.

Prior to the ED, in September 2021, the IASB published a *Request for Information* (RFI); during 2022, it discussed responses to the RFI and, in December 2022, published the *Project Report and Feedback Statement*.

For a summary of these discussions and EY's views, see *Applying IFRS, IFRS 9 PIR Progress to date*.

How we see it

Given the urgency and importance of the issues the ED addresses, users and preparers of financial statements should, as a priority, carefully review the proposals and consider how they would be affected.



Feedback

Please provide us with feedback on today's session:

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EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

Creative Services ref. 8786. Artwork by Khaja AF.

ED None

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