IFRS 9: Derecognition of Financial Liabilities Settled Using Electronic Payment Systems

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Background

In September 2021, the IFRS Interpretations Committee issued a tentative agenda decision to address a request it received about the recognition of cash received via an electronic transfer system as settlement for a financial asset. The submission asked whether an entity could derecognize a trade receivable and recognize cash on the date an electronic cash payment is initiated by the counterparty (e.g., its reporting date), rather than on the date the electronic cash payment is received when there is a multi-day settlement period. The Group discussed the Committee's tentative agenda decision at its December 2021 and September 2022 meetings. At its meeting in September 2022, the IASB determined that they would not approve the issuance of the Committee's tentative agenda decision due to concerns raised by respondents of the potential broader implications that finalization of the tentative agenda decision could have for the derecognition of financial liabilities. Instead, the IASB undertook a standard-setting project to address the issue with a specific focus on the derecognition of financial liabilities settled through electronic payment systems.

In May 2024, the IASB published "Amendments to the Classification and Measurement of Financial Instruments – Amendments to IFRS 9 and IFRS 7," which includes amendments to address how an entity would determine the date of derecognition of financial assets and financial liabilities, such as trade receivables and trade payables, respectively.

The new paragraph B3.1.2A in the amendment clarifies that a financial asset is derecognized on the date that the contractual rights to the cash flows expire or the asset is transferred. Similarly, the amendment states that a financial liability is derecognized on the settlement date, which is the date on which the liability is extinguished because the obligation specified in the contract is discharged or cancelled or expires *unless* an entity is eligible for, and elects to apply, the exception also added to IFRS 9 as part of the amendments. Specifically, paragraph B3.1.2A of IFRS 9 states:

> Unless paragraph 3.1.2 applies, an entity shall recognise a financial asset or financial liability on the date on which the entity becomes party to the contractual provisions of the instrument (see paragraph 3.1.1). A financial asset is derecognised on the date on which the contractual rights to the cash flows expire or the asset is transferred (see paragraph 3.2.3). Unless an entity elects to apply paragraph B3.3.8, a financial liability is derecognised on the settlement date, which is the date on which the liability is extinguished because the obligation specified in the contract is discharged or cancelled or expires (see paragraph 3.3.1) or the liability otherwise qualifies for derecognition (see paragraph 3.3.2).

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The purpose of this agenda item is to discuss the high-level implications of the amendments to IFRS 9 related to the derecognition of financial liabilities, and the criteria which an entity would need to meet in order to derecognize a financial liability on a date earlier than the settlement date.

Consider the following example of current practice for the derecognition of a financial liability settled through electronic payment:

- A Canadian entity has a material trade payable due to a third party.
- The entity initiates an electronic payment to settle the trade payable one day before its period end.
- Once the electronic payment is initiated, the entity's bank account balance is reduced to reflect the transfer of cash.
- The entity's current accounting practice is to credit cash and debit (reduce) trade payables for the same amount on the date electronic payments to third parties are initiated.
- The electronic payment system used by the entity takes three days to settle the transaction.

Applying its current accounting practice, the entity's period-end financial statements would reflect the fact that the trade payable has been settled via the electronic payment initiated the previous day. However, if the electronic payment system used by the entity takes three days to settle the transaction, the counterparty will only receive the cash in their bank account two days after the entity's period end.

The practice of derecognizing financial instruments when a payment is initiated using an electronic payment system instead of when the payment is received by the counterparty is consistent with the concept of applying trade date accounting to the derecognition of financial assets and financial liabilities. However, the Committee's discussion and tentative agenda decision clarified that trade date accounting only applies to the regular way purchase and sales of financial assets and not broadly to the derecognition of financial assets and financial liabilities. Specifically, the Committee's discussion noted that in the submitted fact pattern, the entity is neither purchasing nor selling a financial asset. Therefore, paragraph 3.1.2 of IFRS 9, which specifies requirements for a regular way purchase or sale of a financial asset, is not applicable. The Committee staff also noted the following in their paper analyzing the comment letters on the tentative agenda decision:

> We continue to agree with the Committee that, in the submitted fact pattern, the entity is neither purchasing nor selling a financial asset. Instead, the entity receives cash as settlement for an existing financial asset—the trade receivable from the customer. In our view, the settlement of a trade receivable cannot be characterised as either the 'purchase' of cash or the 'sale' of that trade receivable.
>
> We also note that paragraph BA.4 of IFRS 9 states 'a regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative'. The receipt of cash as settlement for a trade receivable gives rise to no such fixed price commitment.

> We therefore conclude that, in the submitted fact pattern, the requirements in paragraph 3.1.2 of IFRS 9 for a regular way purchase or sale of a financial asset are not applicable[3].

The Committee's discussion and tentative agenda decision highlighted that the current practice of applying derecognition accounting on the transaction initiation date for electronic payments that do not settle on the same day was not supported by IFRS 9. Instead, under the current IFRS 9 liability derecognition guidance, in the simple example above, the financial liability can only be extinguished at the settlement date, three days after the transaction is initiated, when the counterparty receives the cash in their bank account. Although current accounting practice would be for the entity to derecognize the trade payable when the cash leaves the entity's bank account, this will be three days before the counterparty will receive the cash and three days before the conditions are met for the extinguishment of a financial liability under IFRS 9 before the amendment. Paragraph B3.3.1 of IFRS 9 provides the following guidance on when a financial liability, such as a trade payable, is considered to be extinguished:

A financial liability (or part of it) is extinguished when the debtor either:

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

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

Generally, despite the Committee discussions and tentative agenda decision, it is acceptable for entities to continue to follow their current practice of derecognizing financial liabilities settled using electronic payments systems while the IASB undertook standard setting. This is because the outcome of the standard-setting project was unknown until it was completed, and there was an expectation that transition relief would be provided once any amendments were effective.

Exception introduced by the amendments to IFRS 9

The amendments to IFRS 9 introduced an exception to the derecognition rules for liabilities settled through an electronic payment system. The goal of this amendment was to provide practical relief from waiting until settlement to derecognize financial liabilities for entities that use electronic payment systems. However, the exception is not mandatory and entities that wish to avail themselves of the exception need to meet certain requirements.

[3] IFRS Interpretations Committee Staff Paper, AP3, Cash Received via Electronic Transfer as Settlement for a Financial Asset (IFRS 9), June 2022, paragraphs 20-22.

Paragraph B3.3.8 of IFRS 9 (i.e., the exception) only applies to financial liabilities that are settled in cash using an electronic payment system. If this is the case, entities are permitted to deem the financial liability discharged before the settlement date (i.e., before cash is received by the counterparty) only if the entity has started a payment instruction that resulted in:

(a) the entity having no practical ability to withdraw, stop or cancel the payment instruction;

(b) the entity having no practical ability to access the cash to be used for settlement as a result of the payment instruction; and

(c) the settlement risk associated with the electronic payment system being insignificant.

In other words, paragraph B.3.3.8(c) requires that the risk of the payee not getting funds as a result of failure by the payment system to honour its commitment to be very small.

<u>Effective date and transition</u>

Entities are required to apply the amendments for annual reporting periods beginning on or after January 1, 2026, with early application permitted.

Issue 1: Implications of the amendments to the derecognition of financial liabilities settled through electronic payment systems and practical challenges should entities want to apply the exception

Analysis

As noted above, the amendments to IFRS 9 clarified that financial liabilities, such as trade payables, can only be derecognized at the settlement date (i.e., when the cash is received by the payee from the payer). However, when the financial liability is settled in cash through an electronic payment system, the entity can elect to apply an exception that would allow the financial liability (or part of it) to be derecognized before the settlement date only if certain conditions are met. The conditions in paragraph B3.3.8 of IFRS 9 are that:

(a) the entity has no practical ability to withdraw, stop or cancel the payment instruction;

(b) the entity has no practical ability to access the cash to be used for settlement as a result of the payment instruction; and

(c) the settlement risk associated with the electronic payment system being insignificant.

For settlement risk to be insignificant, the payment system must have both of the following characteristics:

- completion of the payment instruction follows a standard administrative process; and
- there is only a short time between the entity (i) ceasing to have the practical ability to withdraw, stop or cancel the instruction and to access the cash and (ii) when the cash is delivered to the counterparty (see paragraph B3.3.9 of IFRS 9).

Settlement risk would not be insignificant if completion of the payment instruction is subject to the entity's ability to deliver cash on the settlement date.

If the entity elects to apply this exception, it is required to apply it to all financial liabilities settled through the same electronic payment system. While the application of the exception is intended to be a practical solution, applying the exception is not automatic. Entities will need to conduct an analysis to prove they can qualify for use of the exception. While the level of analysis that entities need to conduct will depend on the specific circumstances of each entity (e.g., countries in which it operates, level of sophistication of banking system, type of electronic payment system used, etc.), some consideration points could include:

- understanding an entity's use of electronic payment systems to settle liabilities, which could be an inventory of payment systems used. This inventory could include a description of each electronic payment system and the jurisdictions in which the payment system is used;
- understanding the particular payment system's, bank's, or other financial institution's policies that dictate the cut-off time at which a payment instruction can no longer be withdrawn. In practice, the Canadian payment system network includes multiple ways an electronic payment can be made (e.g., Society for Worldwide Interbank Financial Telecommunication (SWIFT) transfers, large value transfer wire payments, electronic transfer pre-authorized payments, etc.). Obtaining an understanding of each of these payment methods, the specific rules surrounding stop-payment, and the timing of settlement will be crucial;
- understanding the specific settlement risk associated with the electronic payment system. While settlement risk within Canadian banking institutions may not be significant, entities operating in developing nations where payment systems are not as sophisticated will need to understand the settlement risk to prove it is insignificant. This practically could result in entities that operate multi-jurisdictionally with different derecognition policies;
- understanding the specific payment system's, bank's, or other financial institution's standard administrative processes including the time frame between meeting the criteria described in paragraph B3.3.8(c)(i) and (ii) of IFRS 9 above to determine whether any possible delay in delivery of cash to the counterparty is of a short duration. Similar to what is discussed above, understanding the different conventions for the different payment methods will also be important.

Some practical challenges associated with applying the exception include:

- **Multiple electronic payment systems and/or cross-border payments.** Entities that operate in multiple jurisdictions or make cross-border electronic payments may find the exercise of determining whether it is eligible to apply the exception for each electronic payment system challenging at first. Such entities might consider prioritizing the analysis of those electronic payment systems that handle the most volume for the entity, are inherently complex, and/or are in foreign jurisdictions to allow sufficient time to determine whether the conditions to apply the exception are met and identify any issues.

- **Areas of judgment.** While the exception is intended to provide relief to entities, determining whether the conditions to apply the exception are met may require the application of judgment and conclusions about whether the exception can be applied may differ across various payment systems. For example, determining whether an entity has no *practical* ability to withdraw, stop, or cancel the payment instruction, aside from protective rights (e.g., to prevent a fraudulent transaction), will likely require an understanding of the bank's protocols and the capabilities of the electronic payment system. To the extent there is uncertainty about an entity's rights or how the electronic payment system works, an entity may consider whether specialists (e.g., legal) need to be engaged to assist with the analysis.
- **Intercompany balances.** Entities applying the exception should be aware that this could lead to inconsistencies in the accounting for intercompany payables and receivables because the derecognition exception applies only to financial liabilities and not to financial assets. As a result, additional adjustments may be required to eliminate intragroup balances on consolidation.

The Group's Discussion

The Group agreed with the analysis. Several Group members noted that it may be challenging for entities to demonstrate that their electronic payment systems qualify for the new exception. Assessing the functionality of these systems and determining whether each system meets the exception criteria could be onerous, particularly for entities operating in multiple jurisdictions or using various electronic payment systems. Some Group members raised that certain terminology used in the exception paragraph, such as "electronic payment system", "insignificant settlement risk", and "short time" are not clearly defined, requiring judgment as to their interpretation and application.

Some Group members suggested that a centralized analysis of common electronic payment systems used by Canadian entities, including an evaluation of whether each system meets the exception criteria, would be helpful. This would prevent multiple entities from duplicating the same analysis. However, one Group member cautioned that payment systems undergo regular upgrades as technology advances, which could render the analysis of whether any payment system meets the exception criteria obsolete. To avoid this, the analysis should be updated on a timely basis to address any changes made to the underlying electronic payment system(s) that could impact one or more of the conditions required to apply the exception. Another Group member highlighted that the amendments might require significant process or system changes if entities need to alter their accounting practices. Therefore, entities should assess the impact of these amendments to IFRS 9 as early as possible to ensure they have sufficient time to implement any necessary changes to their systems, processes and controls before the effective date.

Issue 2: Implications of the amendments to the derecognition of financial liabilities settled through means other than electronic payment systems

Analysis

The amendments to IFRS 9 consist of two elements:

1) Paragraph B3.1.2A of IFRS 9, which clarifies the general requirements for the derecognition of financial assets and financial liabilities in the scope of IFRS 9, except for those which qualify as regular way purchases and sales; and

2) the introduction of an optional exception to specifically address the timing of derecognition of financial liabilities settled by an electronic payment system.

The first component of the amendments, because it broadly addresses all financial assets and financial liabilities, also clarifies the general requirements for the derecognition of financial liabilities settled through other payment methods (e.g., cheques). In contrast, paragraph B3.3.8 has a narrower scope and only introduces an exception to permit the early derecognition of financial liabilities settled through electronic payment methods. Therefore, once the amendments to IFRS 9 are adopted, an entity that does not apply the exception will only be able to derecognize a financial liability at the date of settlement, which is the date when the payee receives the cash from the payer.

Fact pattern

- Entity A owes Supplier B $100, which is due for payment on January 4, 20X7.
- Entity A has a calendar year-end.
- On December 30, 20X6, Entity A writes a cheque to Supplier B for $100.
- In accordance with Canadian banking convention rules, Entity A has the ability to issue a stop-payment at any point prior to cash being credited to Supplier's B bank account.
- Once Supplier B deposits its cheque, it may take additional business days for Supplier B's bank to obtain confirmation from Entity A's bank that there are sufficient funds to settle the amount. Until that confirmation is obtained, Supplier B's bank is essentially advancing the funds to Supplier B.

Paragraph B3.1.2A, which is a newly added paragraph to IFRS 9, is relevant to determining when financial liabilities should be derecognized. It states that:

> Unless an entity elects to apply paragraph B3.3.8, a financial liability is derecognised on the settlement date, which is the date on which the liability is extinguished because the obligation specified in the contact is discharged or cancelled or expires (see paragraph 3.3.1) or the liability otherwise qualifies for derecognition (see paragraph 3.3.2).

The exception in paragraph B3.3.8 does not apply in this fact pattern as Entity A is not settling its obligation via an electronic cash payment. Furthermore, Entity A has the ability to issue a stop-payment until the cash is credited to Supplier's B bank account, and clearing of the cheque is not automatic. Therefore, Entity A has only extinguished its obligation when cash is credited to Supplier B's bank account. Until then, Entity A should continue to recognize its payable and cash of $100. This is supported by the Basis for Conclusions to the amendments to IFRS 9, where the IASB acknowledged that cheques are subject to settlement risk and would not meet the exception in paragraph B3.3.8 created for financial liabilities. The cheque to Supplier B would not "clear" if Entity A lacked sufficient funds to settle the obligation, leaving Entity A with a liability to the supplier until the cash is delivered (i.e., transferred from the payer's account).

Paragraph BC3.55 in the Basis for Conclusions explains that a financial liability that is settled by cheque is subject to more than insignificant settlement risk until the cash is delivered. It states that:

> Electronic payment systems establish a controlled environment for cash transfers so that the risk of the cash not being delivered to the creditor is minimal (or de minimis). This is because these electronic payment systems follow a standard administrative process to complete transactions. **For other payment methods, such as cheques, completion of the payment remains subject to settlement risk that is more than insignificant until the cash is delivered (that is, transferred from the payer's account). Consequently, the IASB decided not to expand the scope of the requirements beyond electronic payment systems**. (bold added)

Therefore, Entity A would continue to recognize its liability to Supplier B until the cash is delivered (i.e., transferred to Supplier B's bank account) and Supplier B's bank has received confirmation that Entity A has sufficient funds to cover the cheque payment. At that point, the liability to Supplier B is extinguished as the payment is complete and the settlement risk is eliminated.

The Group's Discussion

Group members thought the amendments will result in a significant change in practice for most Canadian entities regarding the derecognition of financial liabilities settled using cheque payments. Most Canadian entities currently derecognize financial liabilities when a cheque is issued. Following the amendment, entities will be required to defer derecognition until the payee receives the funds in their bank account and the settlement process is complete. This process may take several days from the point at which the payee presents the cheque to their bank. Some Group members also noted that the payor may not have visibility into when the cash from the payor's bank account has been deposited into the payee's bank account, which may present challenges in determining the date on which the payor's liability has been settled. In addition, some Group members noted that this will also impact entities' bank reconciliations, as outstanding cheques will no longer be a reconciling item. These changes might require entities to implement significant changes to their existing systems and processes. One Group member cautioned that referring to the amendment as a "clarification" of existing requirements might give the impression that this amendment will have minimal impact on Canadian entities, which is likely not the case.

Overall, the Group's discussion raised awareness of the impact of the May 2024 amendments to the derecognition requirements for financial liabilities in IFRS 9. During its discussion on Issue 1, the Group recommended that the AcSB consider initiating or facilitating the preparation of a centralized analysis of common electronic payment systems used in Canada, including an evaluation of whether each system meets the new exception criteria. They thought this would prevent different entities from needing to duplicate the same analysis.