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Ms Sue Lloyd
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Our ref RD/288

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Dear Ms Lloyd

Tentative Agenda Decision: *Cash Received via Electronic Transfer as Settlement for a Financial Asset (IFRS 9 Financial Instruments)*

We appreciate the opportunity to comment on the IFRS Interpretations Committee's ('the Committee') tentative agenda decision "Cash Received via Electronic Transfer as Settlement for a Financial Asset (IFRS 9 Financial Instruments)" ('TAD'). We have consulted with, and this letter represents the views of, the KPMG network.

Overall, we agree with the Committee's analysis of the issue. Without further standard setting, we agree that the interpretation of the standard in the context of the query is correct. However, in our view, the potential issues arising from the finalisation of the TAD are considerable. Finalising a decision in respect this specific question does not give the Board sufficient opportunity to consider the matters set out in this letter, which in our view apply to a broader set of transaction flows. We believe these matters are best addressed through the Post Implementation Review ("PIR") of IFRS 9 and may require further standard setting with appropriate due process.

In that context, we have set out the parts of the TAD that could have a widespread impact on the financial reporting of preparers, while acknowledging that we agree with the technical analysis.

Application of IFRS 9.3.1.2 (regular way purchase or sale exemption)

The TAD observes that in the fact pattern of the submission, 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.

We agree that the wording in 3.1.2 is clear and that the regular way exemption does not apply to the settlement of a trade receivable (notwithstanding that we are aware such an interpretation has been mooted by some preparers). However, we would encourage the Board to examine that paragraph in the context of the IFRS 9 classification and

measurement PIR. We note that the intention of the regular way exemption under US GAAP, which formed the basis of the IAS 39 treatment (as originally described in para 274 of the Basis for Conclusions of SFAS 133), was as a practical means to avoid derivative treatment for a great many contracts that would otherwise be treated as such because they meet the definition of a derivative. For example, a bond purchase that takes three days to settle would meet the definition of a forward contract without the regular way exemption:

SFAS 133.274 "…Requiring that all forward contracts for purchases and sales of financial instruments that are readily convertible to cash be accounted for as derivatives would effectively require settlement date accounting for all such transactions. Resolving the issue of trade date versus settlement date accounting was not an objective of the project that led to this Statement. Therefore, the Board decided to explicitly exclude forward contracts for "regular-way" security trades from the scope of this Statement…"

The regular way exemption can be seen as an exception to otherwise applicable derivative recognition rules. Without the regular way exemption, the application of the principles of IFRS 9 relating to the definition of a derivative would lead to less relevant financial information. In a similar manner, we believe that the way in which this analysis fundamentally challenges the well-established methods used to prepare bank reconciliations (see below) merits an investigation on whether the regular-way methodology should be extended to settlements.

We would therefore encourage the Board to consider (as part of the PIR) permitting the extinguishment of a financial payable (as per IFRS 9 3.3.1) and receivable (as per IFRS 9 3.2.3(a)) at the commencement of a market standard settlement mechanism. Cash flows that are paid by market standard payment systems such as Swift or the writing of cheques could be deemed to have been paid on instruction rather than on receipt, as a practical expedient. We believe that such a treatment could avoid many of the issues noted below.

Ultimately, the effect is one of reclassification (generally between cash and trade debtors/creditors). The effort involved in implementing the TAD in full (see below) should be considered in light of whether it leads to more relevant and reliable financial reporting for users. Such arguments may help to support an extension of the regular way exemption.

Reliance on legal analysis

We agree with the statements in the TAD that determining the date on which the entity's contractual rights to trade receivable cash flows expire is a legal matter, which would depend on the specific facts and circumstances, including the applicable laws and regulations and the characteristics of the electronic transfer system.

However, in our experience it has not been common practice to perform such a legal analysis in respect of settlements to date. We understand that the diversity in practice in respect of when such cash flows are treated as settled was the main reason the issue was brought to the attention of the Committee.

The legal date and time at which the rights to cash flows expire, or when the automated payment could or could not be cancelled, may differ by jurisdiction as well as by payment mechanism. For example, the date at which a creditor legally fulfils their obligation to pay (or a debtor is legally paid) may differ in one country vs. another, depending on local law. It is also not clear how the ability of one or both parties to cancel a payment mid cycle would change the analysis. An entity that operates in multiple jurisdictions would be required to obtain legal opinions in respect of each of the jurisdictions in which it operates and each of the payment mechanisms that are used in that jurisdiction. Given that there are hundreds of payment processing entities globally, ranging from online retail payment transfer mechanisms and interbank systems to simple cheques written by hand, this could be a large, expensive and time-consuming task that will need to be performed by a great many IFRS reporters.

We would encourage the Board to consider the potential implementation timeframes that will arise on finalisation of the TAD if such legal analysis is required.

Application of the TAD to trade creditors

Although it is not explicitly mentioned in the TAD, IFRS 9 B3.2.15 states that to the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The implication of that is that there is symmetry between the recognition of cash in the books of the entity holding (then derecognising) the trade receivable and the derecognition of a trade payable (and the cash payment) from the books of the entity holding the trade creditor. The alternative – that there is a time period when the cash is derecognised by the payer and not recognised in the books of the payee – would mean that there would be a period when the cash should be recognised by the payment processor. We have not observed such a treatment in our experience and do not believe that would be appropriate in the absence of legal analysis that confirmed the ownership of the cash by the payment processor.

Given the implied symmetry, further questions arise as to the nature of cash held by the payer subject to payment instruction. Cash that is under payment instruction is generally no longer available for withdrawal or other use. For example, an entity that holds 1,000CU cash in an account and instructs the bank to make payment of 900CU under the BACS payment system would expect to be able to make use of only 100CU of the 1,000CU reported in its bank statement after the instruction is made.

It is not clear whether such amounts (the 900CU in the example above) should continue to be shown as cash, restricted cash or whether such amounts qualify as cash equivalents. In our experience, such cash amounts are currently derecognised, along with the associated trade creditor in the books of the payer, at the BACS instruction date. If symmetry would be required, and the cash is not derecognised on payment initiation by the payer, we would welcome the Board addressing the matter through the PIR process.

Application of the TAD to credit card and charge card transactions

Logically, the analysis performed by the staff can be extended to include other payment mechanisms, including credit and debit card transactions. However, when a credit card sale takes place, the receivable recognised by the Merchant is not a “trade receivable” from the customer, rather, it is a receivable from the credit card Acquiring bank from the inception of the transaction.

Different credit card and charge cards in various jurisdictions have different settlement periods with the Merchant, ranging from 24 hours to a number of weeks. Applying the staff analysis in the TAD, the Merchant would be required to perform legal analysis to determine when its rights to the cash flows due under the receivable from the Acquiring bank expire. As noted above, this may require a great deal of effort from retailers across many jurisdictions. Unlike a trade receivable (where a payment made by the creditor is facilitated by a third-party payment processor or bank), a receivable in a credit card transaction due from the payment processor itself – an Acquiring bank.

In addition, given the diverse settlement periods in credit and charge card transactions, the determination of how the settlement period affects the treatment of the receivable from the Acquiring bank (as a cash equivalent – see below) becomes a critical question to avoid diversity in practice.

Cash equivalents in the Statement of Cash Flows and Statement of Financial Position

The TAD states that if an entity’s contractual rights to the cash flows from the trade receivable expire before the transfer settlement date, the entity would recognise any financial asset received as settlement for the trade receivable. Such a receivable would be a very short-lived receivable from the entity that is processing the payment, such as a bank, before it became cash on settlement. This is also true of credit card receivables from an Acquiring bank as noted above.

It is not clear whether the definition of cash equivalent in IAS 7.6 would extend to those receivables. That is, whether a receivable to be settled in (say) 2 days could be considered a “short term highly liquid investment”. The inclusion of such amounts as cash equivalents can impact KPIs that rely on cash as part of the calculation. There may also be an effect on bank covenants if cash balances are part of the covenant calculation.

Treatment of such amounts as cash and cash equivalents could alleviate some of the implications arising from the TAD. We would welcome the committee clarifying how such amounts should be recorded under IAS 7.

Changes in long standing practice

Typically, accounting in many jurisdictions sees a difference between the recorded cash balance in an entity’s books and records (the book balance) and the balance per the bank statement (the bank balance). The two figures are reconciled in a market standard bank reconciliation whereby unpresented items (uncleared cheques for

example) are deducted from the bank statement balance to reconcile the statement to the book balance. In many entities, such a mechanism is largely automated and integrated into the financial reporting system and it is standard practice to record the balance on the book as the cash balance in the financial statements.

The implication of the TAD is that such an automated process is not possible without a full analysis of when mid cycle payments (such as unpresented cheques, or BACS payments after initiation but before settlement) are legally complete. Automated systems would require updating such that payment process items “in transit” are deducted from the correct side of the reconciliation, and that the correct cash balance is recorded in the financial statements.

In some simple cases, it appears that application of the analysis from the TAD would indicate that the financial statements should take the cash balance from the bank statement without adjustment. Even in such cases, while the bank reconciliation control would still serve the same function, there are likely to be system changes required to ensure that it is the bank statement balance that is presented as cash in the financial statements, rather than the book balance.

Given the widespread need for system changes, we believe that it would be more appropriate to tackle this issue as part of the PIR of IFRS 9. The change can be further debated, and reporters provided with a longer notice period in which to make appropriate changes should the suggested change noted under the regular way section above not take place. Please contact Reinhard Dotzlaw at rdotzlaw@kpmg.ca or Colin Martin at colin.martin@kpmgifrg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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