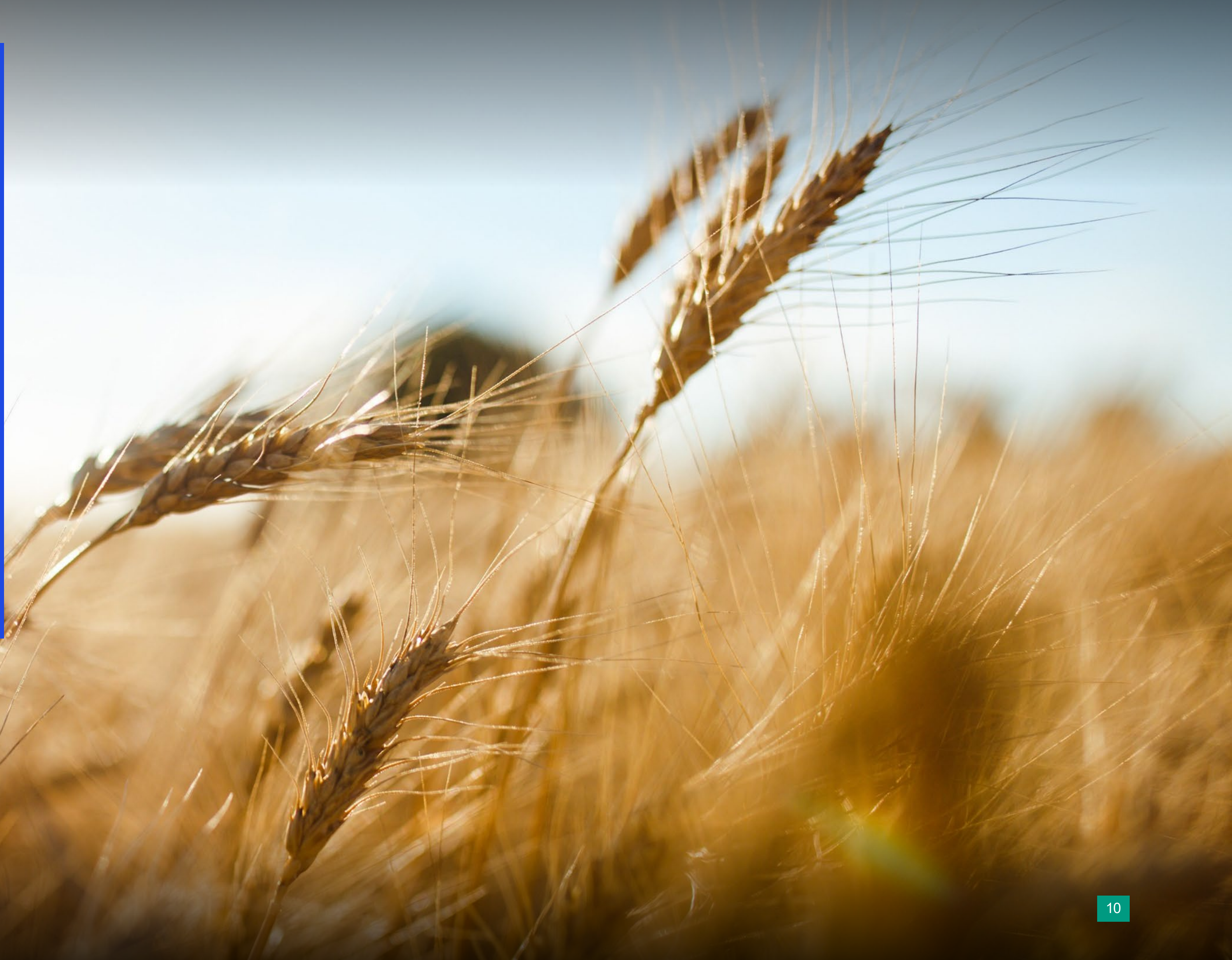
CHAPTER 2

Financial instrument's retrospective amendments on Classification and Disclosures

This article aims to:

Highlight amendments for classification of financial instruments with contingent features such as ESG-linked financial instruments.



Introduction

The International Accounting Standards Board amended financial instruments standard in the area of classification and disclosures setting out guidance for contingent features (including ESG linked features) on classification test of ‘solely payments of principal and interest’ and corresponding disclosures.

Entities would need to recognise the effect of initially applying these 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. Entities need not provide the disclosures required by these amendments for any prior period presented before the date of its initial application of the amendments.

Background

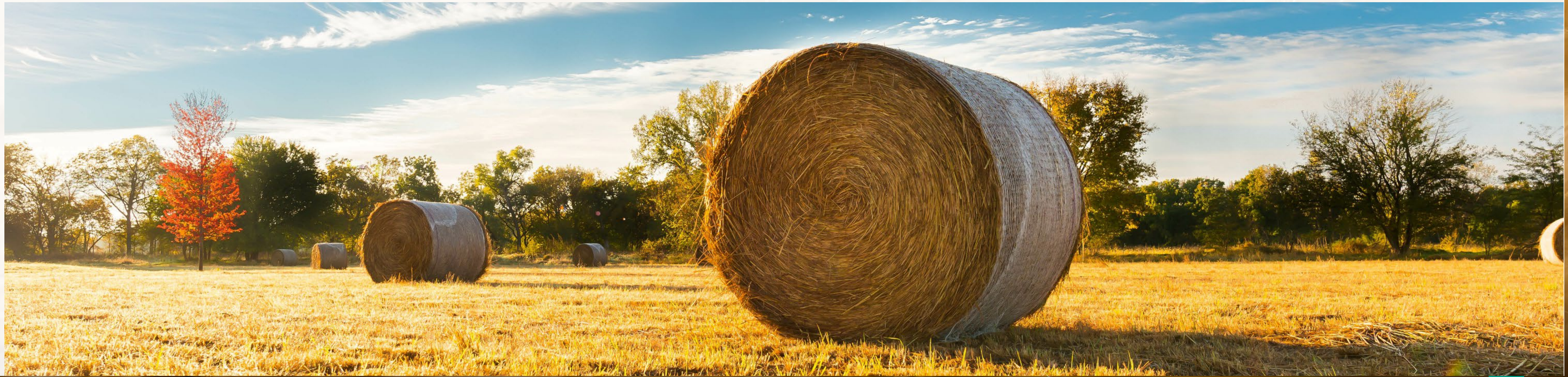
When developing IFRS 9, *Financial Instruments*, the IASB concluded that amortised cost provides useful information about the amount, timing and uncertainty of a financial asset’s future cash flows only if those cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI).

IFRS 9 Post Implementation Review (PIR) revealed the need for clarifications to improve understandability of certain requirements. It was highlighted that it is challenging to apply the SPPI requirement to financial assets with ESG linked features; and amortised cost could provide useful information about these financial assets to users of financial statements.

In other words, under IFRS 9, it was unclear whether the contractual cash flows of some financial assets with ESG-linked features represented SPPI, which is a condition for measurement at amortised cost. Therefore, this could have resulted in financial assets with ESG-linked features being measured at fair value through profit or loss.

In order to avoid diversity in practice, IASB has now provided clarifications on principles for assessing contingent features impacting contractual cash flow to financial assets (including those with linked to environmental, social and governance (ESG) parameters) and additional clarification on financial assets and financial liabilities that have certain contingent features.

Companies having financial instruments with contingent feature not measuring it at fair value through profit and loss, will now be required to provide additional disclosures to clearly understand nature of contingent event.



IFRS 9 and IFR 7 amendments for contingent feature

The amendments introduce an additional test for financial assets with contingent features to meet SPPI test if contingent feature does not change in basic lending risks or costs – e.g. the interest rate on a loan is adjusted by a specified amount if the borrower achieves a contractually specified reduction in carbon emissions. Under this example, returns have changed due to a contingent event and credit risks (lending risk) of borrower will remain unchanged.

While the amendments may allow certain financial assets with contingent features to meet the SPPI criterion, companies may need to perform additional work to prove this. Judgement will be required in determining whether the new test is met.

IASB has introduced following additional SPPI test[1]:

Do the contractual **cash flows**, both **before and after** the contingent event, meet **SPPI?**
- No → Not SPPI
- Yes ↓

Is the nature of the contingent event **related directly to a change in basic lending risks or costs?**
- Yes → SPPI
- No ↓

Are the contractual cash flows **not significantly different from those of an identical financial assest without the contingency** in all contractually possible scenarios?
- Significantly different → Not SPPI
- Not Significantly different → SPPI

IASB has prescribed corresponding additional disclosures for financial instruments with a contingent feature that is not measured at fair value through profit and loss:

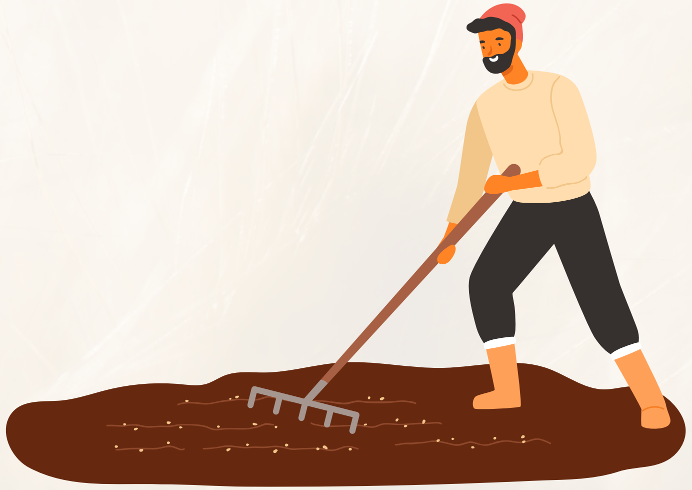
- a qualitative description of the nature of the contingent event
- quantitative information about the range of possible changes to contractual cash flows that could result from those contractual terms
- the gross carrying amount of financial assets and the amortised cost of financial liabilities subject to those contractual terms.

Other IFRS 9 amendments – financial instruments with Non-recourse feature/CLIs

IASB has further provided clarification for financial instruments with Non-recourse feature. Non resource feature means an entity's ultimate right to receive cash flows is contractually limited to the cash flows generated by specified assets. The entity is primarily exposed to the specified assets' performance risk rather than the debtor's credit risk.

While assessing SPPI test for a financial instrument with non-recourse feature, an entity need to evaluate its exposure is not restricted to a asset's performance risk but it extends to a debtor's credit risk. Accordingly, IASB has clarified its existing requirement of 'look-through' test to be extended to assess the link between the particular underlying assets or cash flows and the contractual cash flows of the financial asset being classified to determine whether those contractual cash flows are payments of principal and interest on the principal amount outstanding. The amendment also requires an entity to also consider how this link is affected by other contractual arrangements, such as subordinated debt or equity instruments issued by the debtor.

The amendments have clarified the key characteristics of Contractually Linked Instruments (CLIs) and how they differ from financial assets with non-recourse features. The IASB has also clarified that the underlying pool of instruments under CLIs, can include financial instruments that are not within the scope of IFRS 9, e.g. lease receivables[1].



1. Classification of financial assets, KPMG IFRG Limited, 20 May 2024

IFRS 7 amendments – Disclosures for financial instruments fair valued through other comprehensive income

Companies will now be required to provide following additional disclosures for investments in equity instruments that are measured at fair value with gains or losses presented in other comprehensive income (FVOCI):

- investments derecognised during the reporting period
- investments held at the end of the reporting period
- the cumulative gain or loss transferred within equity on derecognition.

The IASB has clarified disclosures for equity investment measured at fair value through other comprehensive income should be by 'class of investments' instead of earlier requirement for each investment.

Applicability and next steps

The amendments apply for reporting periods beginning on or after 1 January 2026. Companies can choose to early-adopt these amendments (including the associated disclosure requirements), separately from the amendments for the recognition and derecognition of financial assets and financial liabilities.

These amendments are to be applied retrospectively but it should not impact comparative financial information and impact of cumulative effect to be given on the opening balance of financial assets and financial liabilities and the opening balance of retained earnings, if any.

Entities to make sure to evaluate amended requirements for the financial instruments that have contingent feature, non-recourse feature, CLIs and investment in equity instruments fair value through other comprehensive income.