# Staff paper

Agenda reference: 16

## IASB meeting

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| Date | **October 2022** |
| Project | **Contractual Cash Flow Characteristics of Financial Assets (Amendments to IFRS 9)** |
| Topic | **Disclosure, transition and effective date** |
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## Introduction

1. In September 2022, the IASB tentatively decided to make clarifying amendments to the requirements in IFRS 9 *Financial Instruments* for assessing whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI).

2. These clarifying amendments were proposed as part of the standard-setting project added to the workplan by the IASB in May 2022 in response to feedback received on the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (RFI).

3. The purpose of this paper is to consider whether any additional disclosure requirements need to be added to IFRS 7 *Financial Instruments: Disclosures* to complement the proposed clarifications to the requirements in IFRS 9. The paper also considers whether any transition requirements might be needed and the potential effective date of the proposed amendments.

4. The paper is structured as follows:

   (a) disclosure requirements;

   (b) transition and effective date; and

   (c) questions for the IASB.

## Disclosure requirements

5. As discussed in paragraph 17 of Agenda Paper 3B for the April 2022 IASB meeting, some respondents to the RFI considered disclosure to be critical in providing useful information about entities' exposures to ESG-linked risks arising from financial instruments. They suggested the IASB consider adding disclosure requirements along with the classification and measurement requirements.

6. Furthermore, during the June 2022 joint meeting of the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF), CMAC members said that it would be useful to be provided with information about the prevalence and magnitude of instruments with ESG-linked features, including:

   (a) the carrying amount of ESG-linked loans, including as a proportion of total loans; and

   (b) the contractual terms of these instruments and their potential effect on the entity's future cash flows.

7. Although the feedback on the RFI and the requests to clarify the application of the SPPI requirements were in the context of financial assets with ESG-linked features, the staff believe that information about the effect of such features on the contractual cash flows of financial liabilities would equally provide useful information to users of financial statements. We are therefore of the view that any proposed amendments to IFRS 7 have to cover both financial assets and financial liabilities.

8. The overall objective of IFRS 7 (as set out in paragraph 1 of IFRS 7) is to require entities to provide disclosures that enable users of financial statements to evaluate:

   (a) the significance of financial instruments for an entity's financial statements; and

   (b) the nature and extent of risks arising from financial instruments to which the entity is exposed.

9. The IASB tentatively decided at their September 2022 meeting to propose clarifying the application of the SPPI requirements to financial assets with contractual terms that change the timing or amount of contractual cash flows. More specifically, the IASB proposed to clarify that changes to contractual cash flows arising from contingent events with specified characteristics, are consistent with a basic lending arrangement and therefore could be SPPI. Such financial assets could therefore be measured at amortised cost or fair value through other comprehensive income. Similarly, with regards to financial liabilities, if ESG-linked or similar features do not result in an embedded derivative being separated from the host contract (applying the requirements in Section 4.3 of IFRS 9), the financial liability is measured at amortised cost.

10. The staff considered that the effect of ESG-linked features on the contractual cash flows of a financial asset or financial liability that is measured at fair value through profit or loss will be captured by existing disclosure requirements in IFRS 7.

11. Paragraph 20(b) of IFRS 7 requires disclosure of the total interest revenue and total interest expense for financial assets that are measured at amortised cost or fair value through other comprehensive income and financial liabilities that are not measured at fair value through profit or loss. However, there are currently no specific disclosure requirements in IFRS 7 that requires the disclosure of the effect of contractual terms that change the timing or amount of contractual cash flows for financial instruments measured at amortised cost (or financial assets measured at fair value through other comprehensive income).

12. The staff therefore believe that the scope of any proposed disclosure requirements should be aligned with that of paragraph 20(b) of IFRS 7, even though the changes to contractual cash flows discussed in paragraph 9 of this paper might not necessarily affect the amount of interest revenue or expense recognised according to the effective interest method.[1]

13. In general, to understand the nature and extent of risks arising from an entity's financial instruments, IFRS 7 requires disclosures that enables users of financial statements to understand the amount, timing and uncertainty of future cash flows (for example paragraphs 21A and 35A of IFRS 7).

14. Based on our discussions with CMAC members and other similar stakeholders, a description of the nature of contractual terms, ie the contingent events that could change the timing or amount of contractual cash flows, would provide useful information about the likelihood of changes to the cash flows of such financial instruments. As with the clarifying amendments to IFRS 9 discussed in September 2022, the staff do not propose to limit these disclosures only to financial instruments with ESG-linked features. However, instruments with ESG-linked features are an example of the type of financial instruments which would be subject to these disclosure requirements.

15. Stakeholders told us that it would be important to understand the potential magnitude of the changes in the future contractual cash flows. Although the staff agree that understanding the effect of such potential changes to the contractual cash flows on an entity's financial statements is useful information, we also think it is important to balance the potential benefits to users of financial statements with the potential costs to preparers.

16. The staff therefore do not recommend requiring specific quantitative disclosures such as the requirement in paragraph 40(a) of IFRS 7 to disclose a sensitivity analysis, including how profit or loss and equity would have been affected by changes in the relevant risk variable that

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[1] The IASB added a project to its research pipeline on amortised cost measurement and modifications.

were reasonably possible at that date. Unlike market prices which are generally observable, many contractual terms that change the timing or amount of contractual cash flows of financial assets or liabilities depend on contingent events which are specific to the borrower. It is therefore more difficult to present an aggregated analysis of the sensitivity of the entity's financial performance to changes in the conditions underlying these contractual terms.

17. The staff believe that it would enable users of financial statements to assess the possible changes to the amounts and uncertainty of future cash flows if entities disclose quantitative information about the range of possible changes in contractual cash flows (for example, the range of adjustments to the contractual interest rates that could result from contingent events linked to ESG-targets). Consistent with the basis for assessing the contractual cash flow characteristics of a financial asset (as discussed in paragraphs 26 and 27 of Agenda Paper 16A for the September 2022 meeting), we recommend that disclosure of possible changes are based on all possible cash flows and not only those an entity consider probable or likely to occur. In our view, this will mitigate the cost on prepares as entities would not be required to assess the probability for the cash flows of individual instruments to change.

18. To further help users of financial statements to understand the extent of an entity's exposure to such instruments, we are of the view that it is useful to understand the prevalence of financial instruments with such terms, in relation to the entity's total financial assets and financial liabilities within each class. For example, as discussed in paragraph 38 of Agenda Paper 3B for the April 2022 IASB meeting, the market for financial instruments with ESG-linked features is likely to grow. Therefore, disclosing the extent to which such terms are present in an entity's financial instruments would enable users of the financial statements to better understand the uncertainty of the entity's future cash flows.

19. The staff therefore recommend requiring that, for each class of financial assets and financial liabilities not measured at fair value through profit or loss, an entity shall disclose:

    (a) a qualitative description of the nature of the contingent events that could change the timing or amount of contractual cash flows;

    (b) quantitative information about the potential range of changes to contractual cash flows that could result from the contractual terms; and

    (c) the gross carrying amount of financial assets and amortised cost financial liabilities subject to these contractual terms.

## Transition and effective date

20. The proposed amendments to IFRS 9 outlined in Agenda Papers 16A and 16B for the September 2022 IASB meeting are clarifications rather than a change in requirements. However, the staff acknowledge that some entities might need to change their accounting policies when initially applying the amendments, which might require a change in classification for some of their financial assets. The staff therefore recommend specifying transition requirements for such instances, similar to the transition requirements for the initial application of IFRS 9 and previous amendments to IFRS 9, notably *Prepayment Features with Negative Compensation*, issued in October 2017.

21. The staff therefore recommends proposing that an entity should:

    (a) apply the amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in subparagraph (b) (ie modified retrospective approach).

    (b) not be required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in IFRS 9. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

22. The proposal in paragraph 21(b) not to require the restatement of comparatives is consistent with the transition requirements for the initial application of IFRS 9, as set out in paragraph 7.2.15 of IFRS 9. As discussed in paragraph 52 of Agenda Paper 3A for the March 2022 IASB meeting, most respondents to the RFI that provided feedback said the transition requirements generally worked well and the reliefs provided achieved an appropriate balance between reducing costs for preparers and providing useful information to users of financial statements.

23. To the extent that the initial application of the proposed amendments result in a change in the classification of financial assets, we recommend requiring an entity to disclose the following information as at the date of initial application of the amendments:

    (a) the previous measurement category and carrying amount determined immediately before applying these amendments; and

(b) the new measurement category and carrying amount determined after applying these amendments.

24. In the staff's view, an effective date would be best determined after exposure of the proposed amendments. However, we recommend that early application of the amendments is permitted.

## Questions for the IASB

| Questions for IASB |
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| 1. Do you agree with the staff's recommendation for proposed disclosure requirements as set out in paragraph 19 of this paper? |
| 2. Do you agree with the staff's recommendations relating to the transition and effective date as set out in paragraphs 21, 23 and 24 of this paper? |