This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FR Board or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FR Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Targeted Outreach Activities on PFS
Additional questions for outreach

Objective

1 The objective of the session is to discuss additional questions for targeted outreach, particularly for financial institutions.

Topics and questions raised by the IASB Staff

2 The EFRAG Secretariat considers that, in addition to the topics and questions included in agenda paper 04-03, some additional topics should be considered and specific questions should be raised, particularly for financial institutions. In particular:

(a) the classification of hybrid contracts with host liabilities and embedded derivatives;

(b) the classification of derivatives – default category; and

(c) the inclusion in the scope of the requirements for MPMs the numerator or denominator of a ratio, if that numerator or denominator meets the definition of a MPM.

3 Considering the limited timing of the outreach and extended list of topics in the cover note, the EFRAG Secretariat does not recommend expanding this list further to avoid having too many topics for stakeholders to react to.

Hybrid contracts with host liabilities and embedded derivatives

4 When discussing the financing category, some IASB Board members questioned whether financial liabilities measured at fair value through profit or loss would have to be bifurcated into its interest component and present this in financing activities.

5 After considering and discussing this question, the IASB tentatively to require an entity, in relation to hybrid contracts with host liabilities and embedded derivatives, to classify:

(a) income and expenses relating to separated host liabilities to be classified in the same way as income and expenses **on other liabilities;**

(b) income and expenses relating to separated embedded derivatives to be classified in the same way as income and expenses on **stand-alone derivatives**;

(c) income and expenses related to contracts that are not separated to be classified in the same way as income and expenses **on other liabilities.**

6 In addition, the IASB tentatively decided to develop disclosure requirements for the situation in which an entity designates an entire hybrid contract as at fair value

through profit or loss and as a result does not separate from the host financial liability an embedded derivative that is otherwise required to be separated by IFRS 9 *Financial Instruments*. The objective of these disclosure requirements would be to give users of financial statements information about when the use of the fair value option changes the classification of income and expenses.

7 Finally, for liabilities that arise from transactions that do not involve only the raising of finance and that:

(a) are hybrid contracts in the scope of IFRS 9 measured at amortised cost; and

(b) include an embedded derivative the economic characteristics and risks of which are closely related to the economic characteristics and risks of the host contract

the IASB decided to explore an approach that would classify all income and expenses in the financing category of the statement of profit or loss.

EFRAG Secretariat analysis/recommendations

8 In its comment letter, EFRAG did not make specific comments on hybrid instruments and their classification. In general, the EFRAG Secretariat supports the IASB's tentative decision on how to classify income and expenses that arise from host liabilities and embedded derivatives.

9 The EFRAG Secretariat also agrees that when the embedded derivative is not separated from the host liability, it is beyond the scope of this project to require additional disaggregation beyond that required by other Standards.

10 The EFRAG Secretariat includes below an example of its understanding of how the IASB tentative decisions would apply:

(a) a **loan with repayments linked to a commodity price** an entity is exposed to risk relating to that commodity price through its operating activities and uses a derivative embedded in the loan to manage that risk:

(i) applying the IASB's tentative decision, the loan would be treated as a liability that is solely financing with all income and expenses classified in the financing activity;

(ii) the gains and losses on the separated derivative used for risk management would be classified in the operating category (please see table below).

11 The EFRAG Secretariat considers that the IASB's tentative decisions would provide guidance on how the IASB's proposals would apply to more complex instruments.

12 However, the EFRAG Secretariat would welcome additional guidance/clarifications, including:

(a) illustrative examples and/or flowchart to help implementation and help preparers understand the mechanics;

(b) better explain what drives the classification for financial instruments where the embedded derivative is not separated from the host liability. That is, whether it is the host liability or embedded derivative that drives the classification; and

(c) the classification of hybrid instruments that involve the issuance of financial instruments on own equity (e.g., convertible bonds). When referring to hybrid contracts, the IASB seems to be focused on hybrid contracts that are under the scope of IFRS 9 and IFRS 16. Nonetheless, the EFRAG Secretariat assesses that often hybrid contracts involve financial instruments on own equity (e.g. convertible bonds which may be a compound instrument or a financial liability in its entirety as the equity conversion option does not meet the fixed-for-fixed condition). In such cases, the classification of the compound

instruments and measurement of the different elements (e.g. measurement of the liability component of a contingent convertible bond) is under IAS 32. Therefore, the EFRAG Secretariat considers that it would be useful to better explain the interaction of the IASB's tentative decisions with financial instruments under the scope of IAS 32.

13 Accordingly, the EFRAG Secretariat would like to confirm whether the IASB's proposals are clear and applicable for those entities that typically deal with complex financial instruments and whether additional guidance is needed. Therefore, the EFRAG would suggest the following additional question to participants.

Additional questions to participants

14 Are the IASB's tentative decisions on hybrid contracts with host liabilities and embedded derivatives clear and easy to apply?

15 Do participants identify any potential implementation and application concerns?

Question for EFRAG FR TEG

16 Do EFRAG FR TEG members agree with having the additional questions to participants as described above?

The classification of derivatives – default category

Proposals in the ED

17 In its Exposure Draft *General Presentation and Disclosures* (ED), the IASB proposed that the classification of fair value gains or losses on derivatives and hedging instruments would be in accordance with the table below:

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Gains or losses on:</th></tr>
<tr><th>Derivatives</th><th>Non-derivative financial instruments</th></tr>
<tr><td rowspan="2">Used for risk management</td><td>Hedging instruments</td><td colspan="2">Classify in the category affected by the risk the entity manages, except when it would involve grossing up gains or losses—then classify in the investing category.</td></tr>
<tr><td>Not designated in hedging relationships</td><td>Apply the classification requirements for hedging instruments except if such classification would involve undue cost or effort—then classify in the investing category.</td><td>Apply requirements for classification in paragraphs 45–55 of the Exposure Draft.</td></tr>
<tr><td colspan="2">Not used for risk management</td><td>Classify in the investing category, except when used in the course of a main business activity—then classify in the operating category.</td><td>Not relevant for this paper</td></tr>
</table>

Feedback received

18 Many European respondents expressed concerns about the proposed classification of fair value gains and losses on derivatives and hedging instruments. These respondents questioned whether the benefits of such classification would outweigh the costs.

19 In addition, some respondents disagreed with the IASB's proposals to use investing category as the default category for classification of gains or losses on derivatives and hedging instruments (e.g. when it would involve grossing up of gains or losses or when the undue cost or effort exception is met as the underlying financial instruments would often be unrelated to the income and expenses from the investing category, which suggested speculation).

20 Finally, some respondents suggested the IASB considers other categories as the default category for derivatives and hedging instruments. For example, the operating category was considered more appropriate in some circumstances.

IASB discussions and tentative decisions

21 After considering the feedback received, the IASB tentatively decided to change its initial approach as underlined below:

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Gains or losses on:
Underlined text is a change from proposals in the Exposure Draft</th></tr>
<tr><th>Derivatives</th><th>Non-derivative financial instruments</th></tr>
<tr><td rowspan="2">Used for risk management</td><td>Hedging instruments</td><td colspan="2">Classify in the category affected by the risk the entity manages, except when it would involve grossing up gains or losses—then classify in the operating category</td></tr>
<tr><td>Not designated in hedging relationship</td><td>Classify as above except if such classification involves undue cost or effort—then classify in the operating category</td><td>Apply requirements for classification in paragraphs 45–55 of the Exposure Draft.</td></tr>
<tr><td colspan="2">Not used for risk management</td><td>Classify in the operating category, unless the derivative relates to financing activities and is not used in the course of the entity's main business activities. In this case, classify in the financing category.</td><td>Not applicable to this paper</td></tr>
</table>

EFRAG Secretariat analysis

22 In its comment letter, EFRAG was concerned that for corporate entities, tracking exchange differences, hedging or risk mitigation activities related to the operating, investing, and financing categories can be burdensome and costly.

23 For financial institutions, EFRAG was concerned about presenting gains and losses on derivatives in the investing category under certain conditions (i.e. exceptions related to grossing up of gains and losses or the undue cost or effort which the IASB proposed requiring classification in the investing category).

24 The IASB's tentative decisions seem to address the issues related to the financial institutions. However, the EFRAG Secretariat would like to confirm with participants whether the IASB proposals can be easily implemented.

Additional questions for participants

25 Do participants identify any potential implementation and application concerns the classification of fair value gains or losses on derivatives and hedging instruments?

Question for EFRAG FR TEG

26 Do EFRAG FR TEG members agree with having the additional questions to participants as described above?

The inclusion in the scope of the requirements for MPMs the numerator or denominator of a ratio, if that numerator or denominator meets the definition of a MPM

27 The IASB has tentatively decided to include in the scope of the MPM requirements the numerator or denominator of a ratio, if that numerator or denominator meets the definition of an MPM. For example:

(a) if an entity uses **'adjusted earnings per share',** then the 'adjusted earnings' (the numerator) will have to be included in a single note in the financial statements accompanied by disclosures;

(b) if an entity uses the ratios **'EBITDA / Total Revenue'** and **'EBIT / Capital employed'**, then EBITDA and EBIT will have to be included in a single note in the financial statements accompanied by disclosures (*assuming that EBITDA and EBIT are not exactly the same as those specified by the IASB:

'profit before financing and income tax' and 'operating profit before depreciation, amortisation and specified impairments');

(c) if an entity uses the ratios adjusted **ROE**, **ROA** and **ROTE**, then the 'adjusted net income' will have to be included in a single note in the financial statements accompanied by disclosures.

28 Often the subtotals used in a ratio are also used on their own as performance measures and are therefore in the scope. However, they may be excluded from the scope when they are included solely in a ratio (e.g., 'adjusted earnings' used in adjusted earnings per share).

29 The IASB tentatively decided **not to** further explore expanding the scope of MPMs to include measures based on line items presented in the statement(s) of financial performance, cash flows and financial position. The IASB also did not expand the scope of MPMs to include ratios.

30 This is because many IASB Board members were concerned about the complexities arising from the need for additional guidance, potential changes to the disclosure requirements and potential changes to the definition of management performance measures.

31 These members were also concerned about the risks to both the project timeline and other proposals within the project resulting from the need for further outreach and testing of any new proposals and potential stakeholder reaction to any required changes to the requirements.

32 However, the decision was not unanimous.

33 If the IASB does not expand the scope of MPMs, it should at least allow entities to disclose those related to the statement of financial position and ratios (e.g. net debt-to-EBITDA) as it would help management to better explain how it manages its business and improve comparability (as ratios' calculation vary in practice).

Additional questions for participants

34 The IASB expanded the scope of MPMs by including the numerator or denominator of a ratio, if that numerator or denominator meets the definition of an MPM. In this regard:

(a) *How often do you consider that ratios would contain a numerator or denominator which would qualify as an MPM? When do you expect such situations to occur?*

(b) *Do you consider useful to have only the numerator or denominator as an MPM, if it meets the definition of an MPM, and not the ratio itself? What are your views considering situations where both the numerator and denominator are qualified as MPMs but not the ratio?*

(c) *Do you think that the proposed requirement to include the numerator or denominator of a ratio in the scope of MPMs will result in:*

(i) *useful information for users (as ratios are often calculated differently);*

(ii) *significant costs for preparers?*

35 Do you consider that entities should explain why the numerator or denominator are not individually MPMs without considering the ratio?

Question for EFRAG FR TEG

36 Do EFRAG FR TEG members agree with having the additional questions to participants as described above?