Primary Financial Statements
Update on Subtotals and Categories

Objective

1 The objective of the session is to provide an update to EFRAG FR TEG members on the latest IASB's tentative decisions in March 2023 (which have not been discussed by the EFRAG FR TEG and EFRAG User Panel on 10 May 2023) on outstanding issues related to subtotals and categories in the statement of profit or loss.

Structure of the document

2 In the following sections, for each of the topics listed below, it is provided a summary of the IASB proposal in the Exposure Draft *General Presentation and Disclosures* ("the ED"), EFRAG's position in its final comment letter, the latest IASB discussions and decision and the EFRAG Secretariat analysis.

3 The topics to be discussed on subtotals and categories are:

(a) Issues for categories in the statement of profit or loss (IASB AP21E, March 2023); and

(b) Issues related to the proposals for entities with specified main business activities (IASB AP21F, March 2023).

Subtotals and categories: Issues for categories in the statement of profit or loss

Foreign exchange differences on liabilities that arise from transactions that do not involve only the raising of finance that are denominated in a foreign currency

IASB proposal in the ED

4 In accordance with the IASB's 2019 ED, foreign exchange differences recognised in profit or loss would be classified in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to them. For example, foreign exchange differences on trade payables on regular credit terms would normally be classified in the operating category, whereas foreign exchange differences on financing liabilities would normally be classified in the financing category.

EFRAG Final Comment Letter

5 In its final comment letter, EFRAG considered that the IASB should provide more guidance and examples on the classification of foreign exchange differences and of fair value gains and losses on derivatives and hedging instruments to ease implementation.

IASB discussions and tentative decisions

6 In response to the IASB's ED, the IASB's stakeholders expressed concerns about the costs involving the allocation of foreign exchange differences to the different categories and questioned whether the benefits of such allocation would outweigh the costs.

7 To address these concerns, in July 2021 the IASB tentatively decided to require an entity to classify foreign exchange differences in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the foreign exchange differences, except when doing so would involve undue cost or effort in which case an entity classifies the foreign exchange differences on the item in the operating category.

8 When discussing this exception in the 2022 target outreach, stakeholders expressed concerns that it may be counterintuitive to present 'income and expenses from foreign exchange differences' in the operating category when using the undue cost or effort relief while related 'interest expense and the effect of changes in interest rates on other liabilities' are classified in the financing category. For example, payables for goods and services received negotiated on extended credit terms in a foreign currency would involve:

(a) income and expenses that arise from the purchase of goods and services in the operating category;

(b) interest expense and the effect of changes in interest rates on other liabilities in the financing category (without the possibility to reclassify to the operating category).

9 The question is where the income and expenses from foreign exchange differences that arise from other liabilities should be presented. Always in the operating category? Always in the financing category? Or should it be split between operating and financing category?

10 To address this concern, the IASB staff recommended the IASB to require an entity to classify foreign exchange differences on other liabilities in the operating category. Such an approach would also have the benefit of reducing costs as an entity would not have to assess which portion of the foreign exchange differences on the other liabilities should be allocated to the operating category (e.g., income and expenses from the purchase of goods and services) and financing category (e.g., interest expense).

11 After discussing the IASB's Staff recommendation, the IASB ended up <u>tentatively deciding to require an entity to use its judgement to determine in which category in the statement of profit or loss to classify foreign exchange differences on a liability that arises from a transaction that involves operating activities in addition to the raising of finance</u> (i.e., entities should apply the general principle and consider the nature of foreign exchange differences when determining how to classify this in the statement of profit or loss).

EFRAG Secretariat analysis

12 The EFRAG Secretariat welcomes the IASB's tentative decision as it is aligned with the general principle of classifying foreign exchange differences in the same category as the income and expenses from the items that gave rise to the foreign exchange differences.

13 The EFRAG Secretariat considers that the foreign exchange differences on other liabilities may be related to both operating and financing activities, thus an entity should use its judgement to determine in which category in the statement of profit or loss to classify foreign exchange differences (except when it uses the undue cost or effort relief).

14 However, it would be useful to clarify whether and how an entity should bifurcate income and expenses that arise from foreign exchange differences on other liabilities into different categories. For example, when an entity recognises income and expenses on payables for goods and services received negotiated on extended credit terms, whether an entity should bifurcate the income and expenses that arise from foreign exchange differences into those linked to the purchase of goods and services (typically in the operating category) and those linked to interest expense from time value of money (typically in the financing category).

Questions for EFRAG FR TEG

15 Do EFRAG FR TEG members have any comments on the IASB's tentative decisions?

16	Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

Classification of income and expenses from specific hybrid contracts with host liabilities that arise from transactions that do not involve only the raising of finance and are measured at amortised cost in their entirety

IASB proposal in the ED

17 The IASB's ED did not include specific proposals on hybrid contracts with host liabilities and embedded derivatives.

IASB discussions and tentative decisions

18 The IASB started to discuss the classification of hybrid contracts with host liabilities and embedded derivatives in July 2021 and tentatively decided to classify:

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

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

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

19 For liabilities that arise from transactions that do not involve only the raising of finance, except some liabilities specified by the IASB, the IASB tentatively decided to require an entity to classify in the financing category of the statement of profit or loss interest expense and the effect of changes in interest rates when such amounts are identified applying the requirements of IFRS Accounting Standards. However, the IASB specified that this tentative decision did not apply to 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.

20 In relation to these specified liabilities, the IASB decided at the time to explore an approach that would classify all income and expenses in the financing category of the statement of profit or loss.

21 In March 2023 the IASB rediscussed the classification of income and expenses from specific hybrid contracts with host liabilities that arise from transactions that do not involve only the raising of finance and are measured at amortised cost in their entirety (i.e., those identified in paragraph 19 and paragraph 20 above).

22 For example, a payable for goods or services received with extended credit terms that includes an early repayment option. Such a contract could give rise to income and expenses resulting from the changes in the expected future cash flows of the instrument as and when expectation regarding the use of the early repayment option is updated (IFRS 9 includes examples of other hybrid contracts with a host liability and an embedded derivative that would be measured at amortised cost in its entirety).

23 Applying the IASB's revised definition of the financing category to such instruments (i.e., tentative decisions in July 2021), interest is classified in the financing category and other income and expenses are classified in the operating category.

24 To simplify and be consistent with the measurement of the hybrid contract as a single unit of account, the IASB staff explored an approach that would classify all income and expenses

of such instruments in the financing category of the statement of profit or loss (even if, in some rare cases, a transaction may result in income and expenses that are more appropriately classified in another category).

25 After discussing the IASB's Staff proposal, the IASB agreed with the IASB Staff and <u>tentatively decided to and require an entity to classify in the financing category of the statement of profit or loss all income and expenses arising after initial recognition from hybrid contracts:</u>

(a) <u>with host liabilities that arise from transactions that do not involve only the raising of finance; and</u>

(b) <u>that are measured at amortised cost in their entirety.</u>

EFRAG Secretariat analysis

26 In 2022, when discussing the classification of hybrid contracts, preparers (particularly from the banking industry) considered that the IASB's tentative decisions were unclear and asked for more application guidance on the meaning of the IASB's tentative decisions, particularly on the meaning of "in the same way as income and expenses on other liabilities".

27 More specifically, it was unclear whether the 'other liabilities' were related to other liabilities that should always be presented outside of the operating category and thus the accounting policy choice in paragraph 51 of the ED would not apply. When referring to specific instruments, these preparers were concerned that hybrid contracts measured at fair value in its entirety were now being captured by 'specified income and expenses from other liabilities' and could not be reclassified into operating profit.

28 There were also doubts on the classification of separated host liabilities.

29 In terms of recommendations, EFRAG welcomed in its *Summary Report and Recommendations* the IASB's tentative decision to develop application guidance for hybrid contracts. Nonetheless, EFRAG suggested that the IASB further clarified its guidance, particularly to better explain the classification of hybrid contracts that arise from transactions that do not involve only the raising of finance.

30 At this stage, the EFRAG Secretariat considers that the IASB has not yet clarified completely the classification of hybrid contracts.

31 In January, the IASB Staff mentioned that the issues related to the definition of financing category would be addressed in the drafting process (including hybrids and the meaning of 'in the same way as income and expenses on other liabilities').

32 In the agenda paper 07-02 for the EFRAG FR TEG-CFSS meeting on 15 March 2023, the EFRAG Secretariat specifically mentioned in slide 11 "Although the IASB is planning to address the issues related to the financing category in the drafting stage, the EFRAG Secretariat will have to assess in the future to what extent EFRAG's requests have been addressed".

33 The EFRAG Secretariat expresses some concerns about addressing issues in a drafting process as there is the risk that they may not be discussed in a public meeting.

Questions for EFRAG FR TEG

34 Do EFRAG FR TEG members have any comments on the IASB's tentative decisions?

35 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

Subtotals and categories: Issues related to the proposals for entities with specified main business activities

The accounting policy choice for the classification of income and expenses arising from cash and cash equivalents

IASB proposal in the ED

36 Paragraph 51 of the IASB's 2019 ED proposed that an entity that provided financing to customers as a main business activity classified in the operating category either (as a free option):

(a) income and expenses from financing activities, and from cash and cash equivalents, that relate to the provision of financing to customers; or

(b) all income and expenses from financing activities and all income and expenses from cash and cash equivalents.

37 The ED also proposed to classify in the operating category income and expenses from cash and cash equivalents if an entity, in the course of its main business activities, invests in financial assets that generate a return individually and largely independently of other resources held by the entity.

EFRAG Final Comment Letter

38 In its final comment letter, EFRAG agreed with the IASB's proposal for entities that provide financing to customers as a main business activity, as it provides relevant information to users of financial statements.

39 EFRAG considered that the 'free' accounting policy choice in paragraph 51(b) of the ED (for entities that provide financing to customers), while being mainly useful for banks, as noted in paragraph BC66 of the Basis for Conclusions, may result in the loss of relevant information for users, when used by non-financial institutions (e.g., manufacturer providing financing to customers).

40 EFRAG also highlighted the importance to clarify the notion of the 'entity's main business activity' to support its implementation.

IASB discussions and tentative decisions

41 In its redeliberations, the IASB tentatively decided that an entity should classify income and expenses from cash and cash equivalents in the investing category.

42 In addition, the IASB decided to explore withdrawing the accounting policy choice in paragraph 51 for classifying income and expenses from cash and cash equivalents for entities that provide financing to customers as a main business activity because it expected that many entities that provide financing to customers as a main business activity will also invest in financial assets as a main business activity. For such entities the requirement to classify in the operating category all income and expenses from cash and cash equivalents would be triggered by their investments in financial assets and no requirement in relation to providing financing to customers as a main business activity would be needed.

43 Nonetheless, some participants of the IASB's roundtables expressed concerns that if the IASB decided to withdraw the accounting policy choice, entities that provide financing to customers as a main business activity but do not invest in financial assets as a main business activity would have to classify income and expenses from cash and cash equivalents in the investing category (e.g., non-financial conglomerates). In addition, a few financial institutions said that, in their view, the accounting policy choice for the classification of income and expenses arising from cash and cash equivalents should be retained because

they did not view their business as comprising two separate business activities of investing and financing and would find the distinction between the two artificial.

44 After considering the feedback received, the IASB Staff recommended that the IASB retain the accounting policy choice for the classification of income and expenses arising from cash and cash equivalents for entities that provide financing to customers as a main business activity as proposed in paragraph 51 of the ED and clarify the relationship with paragraph 52(a) of the ED.

45 After discussing this topic, the IASB tentatively decided:

(a) to confirm the accounting policy choice proposed in paragraph 51 of the ED for the classification of income and expenses arising from cash and cash equivalents for entities that provide financing to customers as a main business activity; and

(b) to clarify that the requirement in paragraph 52(a) of the ED applying to an entity that invests in financial assets as a main business activity would apply regardless of whether the entity has any other specified main business activity.

EFRAG Secretariat analysis

46 In its *Summary Report and Recommendations*, EFRAG considered that the accounting policy choice in paragraph 51 of ED should continue to apply, even if the IASB retains its tentative decision to classify income and expenses from cash and cash equivalents in the investing category.

47 For non-financial institutions, it is important that paragraph 51(a) continues to apply, however EFRAG noted that paragraph 51(b) of the ED was mainly useful, as mentioned in paragraph BC66 of the ED, for banks that typically provide financing to customers as part of their main business activities (thus, not appropriate to non-financial institutions).

48 Therefore, the EFRAG Secretariat welcomes the IASB's tentative decision, but continues to support the views expressed on paragraph 47 above for non-financial institutions, which would typically affect conglomerates that provide financing to customers but do not have investing activities (e.g. automotive industry with financing to customers).

Questions for EFRAG FR TEG

49 Do EFRAG FR TEG members have any comments on the IASB's tentative decisions?

50 Do EFRAG FR TEG members agree with the EFRAG Secretariat analysis?

Appendix 1

51 Feedback for which the IASB concluded no further action is required.

Issue	Why no further action is needed
Classification of foreign currency differences – disagreement that the default category is the operating profit when the undue cost or effort relief is applied and suggestion to include all foreign exchange differences in a single line item	It was considered that this feedback does not introduce new information and that the IASB has already considered it when making tentative decisions in July 2021.
Classification of interest and penalties on income taxes – there were requests for clarifications on how to classify interest and penalties on income tax.	It was considered that an entity would need to determine the category in the statement of profit or loss for classifying the interest or penalty on income taxes based on the facts and circumstances giving rise to that interest or penalty
Disclosure requirements for hybrid contracts designated at fair value through profit or loss with host liabilities that arise from transactions that do not involve only the raising of finance – as requested by the IASB in July 2021	It was considered that there was no need for specific disclosure requirements for these hybrid contracts because the use of the fair value option for such instruments is likely to be rare; the entity is already required to provide some disclosures under IFRS 7 which may help users understand the difference in the carrying amount resulting from electing the fair value option; and requiring the disclosure of the amounts of income and expenses that would have been classified differently had the fair value election not been used may be contrary to the basis for which the IASB permits the fair value option.
Classification of the change in the value of the undesignated forward element of a forward contract or the foreign currency basis spread of a financial instrument - some stakeholders have requested that the IASB clarifies where the change in the value of the undesignated portion is classified in the statement of profit or loss	The IASB staff will clarify in drafting that when the ineffectiveness of a hedge relationship is recognised directly in profit or loss, income, and expenses from both the effective and ineffective portions are classified in the same category
Classification of loan commitment fees - Some stakeholders asked the IASB to clarify how to classify origination fees for loan commitments that cannot be settled net in cash or another financial instrument, and are not designated as financial liabilities at fair value through profit or loss	It was considered that specific guidance on classification of loan commitment fees is not required, because it is clear that applying the IASB's tentative decisions: (a) loan commitment fees paid or received that are an integral part of the effective interest rate of the loan originated are accounted as part of the interest income or

	expense, and are classified accordingly in the statement of profit or loss; (b) loan commitment fees received that are accounted for in accordance with IFRS 15 are classified in the operating category in the statement of profit or loss, given in both scenarios considered above under which the fees are in scope of IFRS 15, the commitment does not result in the origination and recognition of a financial asset in the statement of financial position; and (c) loan commitment fees paid on commitments that expire without the loan being drawn down or in cases where it is unlikely that the loan will be drawn down are classified in the operating category because they do not meet the requirements to be classified in the financing category given the commitment does not result in the recognition of a financial liability in the statement of financial position.
Classification of income and expenses on liabilities arising from issued investment contracts with participation features (in the scope of IFRS 9) or insurance contracts when neither are issued as part of an entity's main business activity – questions on whether such income and expenses should be classified in the operating category.	IASB Staff recommended the IASB revise the wording in the Basis for Conclusions to clarify that it intends that the requirements in paragraphs 52(b) and 52(c) are not limited to entities with specified main business activities, but applicable to all entities issuing investment contracts with participation features or insurance contracts.
Classification of interest expense on lease liabilities for entities that sublease assets as an intermediate lessor - A few targeted outreach participants said that some entities sublease assets as an intermediate lessor and questioned whether interest expense on lease liabilities should be included in the operating category by these entities.	Under the IASB's revised definition of financing category, interest expense on lease liabilities is no longer subject to the accounting policy choice in paragraph 51 of the ED and is classified in the financing category by all entities. Therefore, intermediate lessors will no longer be able to classify interest expenses on lease liabilities in the operating category. Based on the IASB Staff analysis, it was concluded that no exception is required for intermediate lessors to classify interest expense on lease liabilities in the operating category because (a) subleases are generally operating subleases rather than finance subleases; (b) subleasing is not likely to be a main business activity for the entities analysed with finance subleases; and

	(c) the issue raised in targeted outreach is not likely to be prevalent in practice.
Classification of income and expenses arising from obtaining finance from customers as part of a main business activity - one participant noted that they obtained financing from customers by holding customer deposits but did not provide financing to customers - expenses on its customer deposits are part of its main business activities and classifying them in the operating category would provide better information to the users of its financial statements (which would not be possible under the IASB ED)	The IASB staff noted that field-work results did not indicate that the issue raised would be widespread and that it is difficult to develop a principle-based exception. Thus, the IASB did not consider necessary to provide a further exception for entities that obtain financing from customers but do not provide financing to customers.