IFRS

# STAFF PAPER

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| **Project** | **Financial Instruments with Characteristics of Equity (FICE)** |
| Paper topic | Summary of feedback—presentation of financial liabilities |



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## Objective

1. In this paper the staff summarise the detailed feedback received from comment letters and during outreach with stakeholders on Question 7 of the Discussion Paper *Financial Instruments with Characteristics of Equity* (DP) which addresses the separate presentation of financial liabilities. Feedback from users of financial statements on this question is discussed separately in Agenda Paper 5D.

2. This paper is structured as follows:

   (a) Background and questions in the DP (paragraphs 3-7);

   (b) Key messages (paragraphs 8-10);

   (c) Separate presentation of financial liabilities (paragraphs 11-56); and

   (d) Hybrid instruments (paragraphs 57-63).

## Background and Questions in the DP

3. Under both IAS 32 *Financial instruments: Presentation* and the DP, some instruments are classified as financial liabilities because they include an obligation to pay cash other than at liquidation. However, their amounts are linked to the

'residual value' of the issuer. In accordance with the Board's preliminary view in the DP, further information on the amount feature should be provided through separate presentation of the following financial liabilities:

(a) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(b) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(c) partly independent derivatives that meet the following criteria:

   (i) the derivative has a net amount that otherwise is unaffected by any other independent variable; the only independent variable is a currency other than the entity's functional currency.

   (ii) the foreign currency exposure is not leveraged.

   (iii) the foreign currency exposure does not contain an option feature.

   (iv) the denomination in the foreign currency is imposed by an external factor. For example, the currency denomination is imposed by law or regulation, or market forces are such that denominating the derivative in the entity's functional currency would not have been practically possible.

4. In the Board's preliminary view, to facilitate assessment of balance-sheet solvency and returns associated with those instruments listed in paragraph 3 above, an entity, should:

(a) separately present their carrying amounts in the statement of financial position; and

(b) present income and expenses arising from those instruments in other comprehensive income (OCI) in the statement of financial performance, without subsequent reclassification (recycling).

5. In the Board's preliminary view, no additional presentation requirements need to be developed to provide information about the timing feature because presentation and disclosure requirements in other IFRS Standards such as IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures* provide

sufficient information to facilitate assessments of funding liquidity and cash flows.

6. The Board also considered but did not reach a preliminary view on the application of the criteria-based approach[1] to hybrid instruments. A hybrid instrument may contain an embedded derivative that is partly independent of the entity's economic resources or an embedded derivative with a net amount that is unaffected by any independent variables. For example, a bond may include an 'equity kicker' that, at maturity, obliges the entity to pay cash equal to the difference between the value of a fixed number of the entity's ordinary shares and the contractual amount of the bond. If the hybrid instrument as a whole is measured at fair value through profit or loss applying the fair value option, ie the embedded derivative is not separated from the host contract, the Board considered the following two alternatives:

    (a) Alternative A—apply the separate presentation requirements only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, do not contain any obligation for an amount independent of the entity's available economic resources, for example, shares redeemable at fair value.

    (b) Alternative B—apply the separate presentation requirements to all embedded derivatives regardless of whether they are separated from the host. The entity would be required to separate all embedded derivatives for presentation purposes even though the entity measures the hybrid contract as a whole at fair value through profit or loss.

7. The feedback summarised in this paper is based on the responses provided by stakeholders to the following questions in the DP.

> **Question 7**
>
> Do you agree with the Board's preliminary views stated in [summarised in this Agenda Paper paragraphs 3-5]? Why, or why not?
>
> The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the

[1] See paragraphs 6.24, 6.27 and 6.37-6.41 of the DP.

> presentation requirements as discussed in the DP and [summarised in this Agenda Paper paragraph 6]. Which alternative in [summarised in this Agenda Paper paragraph 6] do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

## Key messages

8. ***Statement of financial position*** - Although many of the respondents that commented on the question about presentation in the statement of financial position disagreed, some agreed with presenting separately the carrying amounts of the financial instruments listed in paragraph 3 above.

9. ***Statement of financial performance*** - some of the respondents that commented on the question about presentation in the statement of financial performance, agreed with presenting income and expenses arising from the financial instruments listed in paragraph 3 above in OCI without subsequent reclassification. However, many respondents disagreed and their views can be categorised as follows:

   (a) not in favour of non-recycling of OCI (see paragraphs 26-31).

   (b) concerns expressed on the proposals related to partly independent derivatives (see paragraphs 32-43). Mainly, they suggested that:

      (i) the proposals should only apply to liabilities that are solely dependent on the entity's available economic resources (see paragraphs 32-34);

      (ii) there is a concern with the criterion in paragraph 3(c)(iv) above related to denomination in foreign currency imposed by an external factor (see paragraphs 35-40); or

      (iii) a disaggregation approach[2] is better (see paragraphs 41-43).

   (c) not supportive of presentation in OCI (see paragraphs 44-55). In summary, these respondents preferred either:

[2] See paragraphs 6.21-6.23 of the DP.

(i) separate presentation in profit or loss (see paragraphs 49-53); or

(ii) disclosures in the notes to the financial statements (see paragraphs 54-55).

10. ***Separation of embedded derivatives*** - regarding the proposal to require separation of embedded derivatives from hybrid instruments measured at fair value through profit or loss for presentation purposes, most respondents supported Alternative A i.e. the separate presentation requirements should apply only to embedded derivatives that are separated from the host and hybrid instruments that do not contain any obligation for an amount independent of the entity's available economic resources. They believe Alternative B ie applying the separate presentation requirements to all embedded derivatives, is too complex, costly and would negate the 'practical relief' under the fair value option in IFRS 9 to measure the entire instrument at fair value through profit or loss.

## Separate presentation of financial liabilities

11. Overall, some respondents welcomed the DP's proposal to provide further information on the amount feature to users of financial statements and said improvements to presentation are important even if stakeholders disagree on the classification approach. It was noted specifically that given that a binary classification approach distinguishes equity and financial liabilities based on some (but not all) features of a financial instrument, information about the other features should be provided through presentation and disclosure.

12. Many respondents also specifically agreed that no additional presentation requirements need to be developed about the timing feature since it is sufficiently covered by the presentation and disclosure requirements in existing IFRS Standards.

13. However, a few respondents did not expressly agree or disagree with the presentation proposals in the DP. A regulator said because they see the statement of profit or loss as the primary source of information about an entity's financial performance for the reporting period, before departing from this presentation, the Board should clarify what exceptional circumstances would justify the re-

measurement of certain classes of financial liabilities in OCI. On the other hand, an accountancy body said they cannot comment on the proposals as they are not fully supportive of the Board's preferred classification approach and questioned why the items mentioned in paragraph 3 of this paper are classified as financial liabilities instead of equity.

14. With regards to the specific proposals in the DP to provide further information on the amount feature through separate presentation of some financial liabilities, there were mixed views from respondents.

15. Some respondents *broadly agreed* with the proposals for separate presentation of financial liabilities in *both* the statement of financial position and statement of financial performance. On the other hand, other respondents *broadly disagreed* with the proposals for separate presentation of financial liabilities in *both* the statement of financial position and statement of financial performance. In some cases, the reasons for disagreement stemmed from a lack of support for the amount feature in the Board's preferred classification approach, while in other cases respondents believed the costs associated with disaggregation on the scale envisaged in the DP would outweigh the benefits from improved information. A particular concern was raised that the separate presentation requirements would introduce a discrepancy between the amount feature (i.e. separate presentation on the face of the primary financial statements) and the timing feature (i.e. additional disclosures only). They said users of financial statements might conclude that the amount feature is more relevant due to the higher prominence given through separate presentation.

16. Some respondents explicitly agreed with the proposals for the statement of financial position but disagreed with the proposals for the statement of financial performance. Their objections, which mainly relate to the use of OCI, have been considered as part of the feedback on the statement of financial performance (see paragraphs 44-48). On the other hand, some respondents only commented on the proposals for the statement of financial position while others only commented on the proposals for the statement of financial performance.

17. A regulator emphasised that it is critical that the concept of 'independent of the entity's available economic resources' is well-understood and easily applied

because the conclusion regarding whether amounts are ‘independent of the entity’s available economic resources’ drives both balance sheet classification and income statement recognition.

### Statement of financial position

#### *Respondents that agreed*

18. Some of the respondents that commented on the presentation proposals for the statement of financial position agreed with the Board’s preliminary views regarding separate presentation of the carrying amounts of the three categories of financial instruments listed in paragraph 3 of this paper in the statement of financial position. They believed it provides useful information and alleviates some of the concerns with the liability classification of these instruments. An accountancy body also noted that the current IFRS Standards only have limited guidance on presentation based on the different features of issued financial instruments and that the proposals will assist in eliminating some diversity they have observed in practice.

19. However, a standard-setting body said the Board should consider how these presentation requirements will interact with the existing requirements in IAS 1 (for example, in terms of minimum line items) and more specifically, whether the separate presentation requirements will be reflected as a separate line item, a new subtotal or a separate category. They noted that presentation may also depend on the Board’s decision on whether to apply the disaggregation or criteria-based approach. If the disaggregation approach is used, only two subclasses of instruments will exist (solely dependent or not dependent), whereas under the criteria-based approach, three categories are needed (solely dependent, partly dependent and not dependent).

#### *Respondents that disagreed*

20. Many of the respondents that commented on the presentation proposals for the statement of financial position disagreed with the Board’s view to present separately carrying amounts of financial instruments listed in paragraph 3 of this paper in the statement of financial position. An accountancy body suggested the Board undertake a cost/benefit analysis before proceeding with the presentation of

information in the statement of financial position. Reasons for disagreeing with the proposals included the following:

(a) transactions with financial instruments listed in paragraph 3 of this paper are likely to be immaterial or not widespread in practice.

(b) paragraph 55 of IAS 1 sufficiently deals with the question of separate presentation on the face of the balance sheet.[3]

(c) it involves significant operational complexity because financial institutions do not generally track derivatives based on whether their net amounts are affected by dependent or independent variables. The Board's proposals may lead to system changes or involve significant manual efforts.

(d) the DP implicitly introduces further categories than debt and equity, by proposing different presentations which are complex, difficult to apply in practice and contradict the principle of a binary distinction. A respondent instead suggested having a third category ‘hybrid capital’ as a complement to the debt and equity categories.

(e) users of financial statements may find it difficult to understand the distinctions between different instruments, particularly partly independent derivatives and it is not clear how much they will benefit from the additional information.

(f) relevant information for users of financial statements is already addressed through the classification of claims in the statement of financial position.

(g) to facilitate the assessments of balance-sheet solvency and returns, the measurement of financial instruments rather than their classification should be considered ie the carrying amount of financial liabilities should be separately presented for each measurement basis.

[3] Paragraph 55 of IAS 1 states that an entity shall present additional line items (including by disaggregating the line items listed in paragraph 54), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity’s financial position.

21. These respondents favoured additional disclosures of the nature and terms of these instruments in the notes to the financial statements. They do not believe further subdividing the face of the statement of financial position into additional categories will provide useful information to users of financial statements because in their view balance sheet classifications are well understood and useful liquidity information is provided through the split between current and non-current assets and liabilities. They believe adding further categories of liabilities may simply clutter or unnecessarily overload the statement of financial position and result in ineffective communication.

22. A standard-setting body further believes disclosure in the notes would better meet the *Conceptual Framework for Financial Reporting* (Conceptual Framework) characteristic of understandability and said this is particularly critical for regulated entities which have additional requirements imposed by regulatory bodies. A few respondents also suggested the Board consider providing an option for entities to present separately the carrying amounts of these financial liabilities, either in the statement of financial position or in the notes depending on their size, nature and amounts.

### *Statement of financial performance*

#### *Respondents that agreed with presentation in OCI without recycling*

23. Some respondents agreed with the Board's preliminary views that income and expenses arising from financial instruments listed in paragraph 3 of this paper are presented in OCI for the following reasons:

    (a) promotes transparency and provides useful information to users of financial statements to better assess the different nuances in the liability assessment, thus enabling a more accurate assessment of balance sheet solvency and returns;

    (b) allows a better depiction in profit or loss of the return the entity produces to satisfy its claims, and thus results in the statement of profit or loss providing more relevant information and more faithful representation of the entity's financial performance for the period;

(c) avoids counter-intuitive accounting in the income statement from recognising gains when an entity performs poorly and losses when an entity performs well;

(d) consistent with the presentation of gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss under IFRS 9; and

(e) if changes in the value of a written put option on non-controlling interests (NCI put) cannot be recognised in equity, OCI is a compromise.

24. A few respondents specifically said they agreed with the proposal to not subsequently reclassify amounts presented in OCI to profit or loss. A standard-setting body said that if changes in the carrying amount of such financial liabilities are irrelevant to the assessment of the entity s financial performance, the same should be true for the cumulative amount to be reclassified from OCI. A few respondents, notably standard-setting and accountancy bodies noted that if gains and losses were not recycled, it would be useful to either require specific disclosure when the instrument is settled (for example how much would have been reclassified if reclassification upon derecognition was required), or require the reconciliation of the amounts recognised in OCI with amounts in equity.

25. Other respondents specifically said they agreed with the criteria-based approach and that it has the merit of reducing implementation costs. In explaining their reasons for supporting the criteria-based approach, it was noted that the disaggregation approach may be unnecessarily complex and difficult to apply in practice and seems inconsistent with the view that derivatives should be classified and measured in their entirety. Furthermore, a standard-setting body said some of their stakeholders noted that the most common example of a feature that would be classified as a partly independent variable would be foreign currency, so it is reasonable to restrict the OCI presentation to foreign currency derivatives. These stakeholders also expressed a view that significant challenges will not arise from applying the proposed criteria because those criteria are similar to the requirements in IFRS 9 for not separating embedded foreign currency derivatives.

### *Respondents that disagreed with non-recycling of OCI*

26. Some respondents commented that they would only support the separate presentation in OCI of income and expenses arising from financial instruments in paragraph 3 of this paper, if there is a subsequent reclassification to profit or loss, with a few others questioning the non-recyclability of this OCI item from a conceptual basis.

27. These respondents referred to the principle in paragraph 7.19 of the Conceptual Framework that income and expenses included in OCI in one period would be reclassified to profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information or a more faithful representation of the entity's financial performance for that future period. This paragraph goes on to say that if for example, there is no clear basis for identifying the period in which reclassification would have that result or the amount that should be reclassified, the Board may in developing Standards, decide that income and expenses included in OCI are not to be subsequently reclassified.

28. They believe the reason stated in the DP for not reclassifying (ie the nature of the income and expenses will not be different in the future and will therefore not be relevant to assessments of performance at a future date) is inconsistent with the examples in the Conceptual Framework on when the Board may decide not to recycle. For both non-derivative financial liabilities and derivatives, they believe the period in which an entity should reclassify OCI and the amount that should be reclassified can be identified.

29. These respondents also said they did not understand the conceptual connection to the presentation of changes in own credit risk of financial liabilities. They noted (as did the DP) that the own credit element of a financial liability designated at fair value through profit or loss which is presented in OCI without recycling, will usually revert to zero by maturity. However, changes in the fair value of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources will not be reversed over the instrument s life. These respondents therefore fail to see why the fair value changes of these instruments are not relevant to assess the issuer's performance and favour an accounting solution that allows recycling.

30. It was also mentioned that if the income and expenses were presented in OCI without subsequent recycling, then it would be better to require equity classification of these instruments and present income and expenses separately as changes in the statement of changes in equity.

31. Furthermore, a few respondents who were not in favour of presentation in OCI commented that if the Board continued with the proposal for separate presentation in OCI then they would prefer recycling.

*Respondents that disagreed with proposals related to partly independent derivatives*

*i) Proposals should only apply to liabilities that are solely dependent on the entity's available economic resources*

32. A few respondents disagreed with applying the separate presentation proposals for partly independent derivatives. They believe amounts presented in OCI should be limited to those arising from movements that are solely dependent on the entity's available economic resources, with all income and expenses on other liability-classified instruments, including partly independent derivatives, presented in profit or loss. Reasons given for not applying the separate presentation requirements to partly independent derivatives were as follows:

    (a) the approach is excessively complex and would further undermine the clarity of the nature of OCI.

    (b) seems to create a different presentation for a subset of claims that meet a very restrictively drafted and rules-based set of conditions which is not appropriate for a principles-based accounting standard.

    (c) the criteria-based approach is arbitrary in that only the foreign currency variable is within the scope and the justification for not treating other independent variables in a similar manner is not clear.

    (d) costs of identifying such financial instruments and the implementation challenges would exceed the benefit of improving information provided about an entity's financial performance.

    (e) unconvinced that either the disaggregation approach or the criteria approach is justified because they both:

(i) incorporate a high level of subjectivity that needs to be supplemented by extensive criteria;

(ii) increase the complexity of presentation without necessarily increasing the usefulness to users of financial statements; and

(iii) further expand the use of OCI.

(f) the notion of partly independent derivatives tries to address issues arising from the application of the proposed definitions. They suggest the Board consider the alternative of allowing exceptions to the classification requirements eg maintaining the foreign currency rights issue exception.

(g) presenting income and expenses in OCI would not provide more relevant information for partly independent derivatives in the trading book.

33. The DP noted that the disaggregation approach could be applied to standalone derivatives and hybrid instruments in the same way without the need for further requirements. However, one of these respondents pointed out that it may be impracticable for some hybrid instruments measured at fair value through profit or loss in their entirety applying the fair value option because the entity may be unable to measure the embedded derivative separately.

34. These respondents suggested some alternative approaches to the proposals in the DP for partly independent derivatives:

(a) split contracts into equity derivative and liability derivative components similar to the requirement in paragraph B4.3.4 of IFRS 9 for accounting separately for multiple embedded derivatives in a single hybrid contract.

(b) retain the foreign currency rights issue exception so that a portion of the population of partly independent derivatives would be classified as equity. This may reduce the need for the separate presentation of partly independent derivatives, particularly if separate presentation is prohibited for hybrid instruments that apply the fair value option.

(c) in respect of derivatives on own equity denominated in a foreign currency, the criteria laid out in paragraph 3(c) of this paper should be used to permit classification in equity and not solely to determine presentation in OCI of the variations in the debt. The proposed criteria provide assurance that there is no leverage effect present and in their view such an instrument should not be classified as debt.

*ii) Concern with criterion in paragraph 3(c)(iv)*

35. A few respondents noted that the assessment of the criteria for separate presentation, particularly whether the denomination in foreign currency is imposed by an external factor or market forces (see paragraph 3(c)(iv) of this paper), may be complex, subject to various interpretations and highly judgemental. They also said that the hurdle of ‘would not have been practically possible’ is too high and ambiguous and should be expanded on.

36. These respondents acknowledged that separate presentation in OCI of income and expenses arising from partly independent derivatives may alleviate calls for extending the foreign currency rights issue exception to conversion options embedded in foreign currency convertible bonds. This is because it addresses their primary concern that treating the conversion option as a liability would bring in unwarranted volatility in profit or loss due to foreign exchange rate fluctuations as well as an entity’s own share price fluctuations. However, they said it is not clear whether the criterion that denomination in the foreign currency is imposed by an external factor is met in the case of foreign currency convertible bonds and this may be extremely difficult to prove. This is because the decision to issue a convertible bond in a foreign currency is purely a commercial decision, driven by factors such as lower interest rates in the foreign currency market and fewer covenants attached to such an issue when compared to a functional currency denominated convertible bond. They also believe resolving the question of whether equity has a currency may have an impact on the classification of foreign currency convertible bonds.

37. Furthermore, a few respondents also explained that multinationals often have shares denominated in several different currencies to access different investor markets or an entity’s ordinary shares were denominated in foreign currency on a

historical basis. In these cases, the derivatives on the equity or rights issues will reference the foreign currency. They said they are not sure whether these derivatives would meet the criteria for separate presentation including the 'practically possible' requirement because the denomination was not required by law, regulation or market forces. It was pointed out that entities that requested the original introduction of the 'foreign currency rights issue exception' may not be able to present income and expenses in OCI if the criteria are not met. These respondents said they would appreciate more guidance or some practical examples.

38. These respondents proposed removing the criterion of demonstrating that the primary reason for denomination in foreign currency is imposition by law/regulation or market forces. A preparer suggested a condition similar to the one in paragraph B4.3.8(d)(iii) of IFRS 9 ie commonly used currency in local business transactions or external trade.

39. A standard-setting body said the Board should consider further developing a narrow scope criteria-based approach akin to an exception that is built on the criteria in paragraph 3(c) of this paper but with the clarification necessary to avoid practice diversity. Since the exception would be narrowly defined, they believe it should be extended to:

    (a) embedded derivatives of hybrid instruments that apply the fair value option, unless an entity determines that doing so would be impracticable (see paragraph 63); and

    (b) non-derivative financial liabilities that otherwise contain no obligation for an amount independent of the entity's available economic resources, if it were not for a variable that meets the criteria.

40. Similarly, another standard-setting body said the criteria-based approach as currently drafted would lead to dissimilar accounting for derivatives and non-derivatives. This is because non-derivative financial liabilities would be presented separately if the amount of the claim is solely dependent on the entity's available economic resources (for example, shares redeemable at fair value). However, it is not clear whether the separate presentation requirements would also apply to non-

derivatives that are partly dependent on the entity’s available economic resources (for example, shares redeemable at fair value in a foreign currency).

*iii) Favour a disaggregation approach*

41. A few respondents favoured a disaggregation approach and disagreed with the Board's proposal to adopt a criteria-based approach to identify the partly independent derivatives which are eligible for separate presentation. While they acknowledged the implementation challenges, a regulator noted that a disaggregation approach would better reflect the substance of the different features of the recognised assets and liabilities. They believe additional disclosures should be provided for users of financial statements to understand the total amount of value changes attributable to each category of instruments which have been subject to disaggregation and separate presentation. They are also concerned that a criteria-based approach may result in an incentive to structure instruments with the objective of presenting the impact of income and expenses arising from independent variables in OCI.

42. A standard-setting body believes the choice between the disaggregation and the criteria-based approaches should be informed by research that establishes the costs that would be incurred by preparers and the relevance and understandability of the information that results from each approach. Furthermore, they noted that one objection to the disaggregation approach is the existence of interdependencies between different variables ie the effect of any one variable can only be identified by an arbitrary allocation. However, they do not believe this is a fatal objection to such an approach because in their view accounting frequently uses arbitrary allocations and this does not necessarily result in information that is meaningless.

43. Another standard-setting body acknowledged that the disaggregation approach is the most conceptually sound approach because splitting the different components of a partly independent derivative would provide a better reflection of the effect of the entity’s own performance in comprehensive income but they also acknowledged its relative disadvantages.

*Respondents that disagreed with presentation in OCI*

44. Many respondents disagreed with presenting in OCI income and expenses arising from financial instruments listed in paragraph 3 of this paper as they do not support what they believe is a new type of liability that expands the use of OCI. Some respondents said they understood the rationale of not presenting in profit or loss but nonetheless had concerns about the use of OCI. The following reasons were given for not presenting income and expenses in OCI, amongst others:

    (a) it increases the complexity of OCI, with a practical question as to whether or not to recycle these amounts to profit or loss.

    (b) lacks conceptual basis and appears to be at odds with the Board's intention detailed in the Conceptual Framework (see paragraph 46). In addition, the creation of a new OCI item to alleviate the concern about counter-intuitive accounting in profit or loss may possibly imply a new concept of 'counter-intuitive' for distinguishing profit or loss from OCI which is not in the Conceptual Framework.

    (c) the OCI category is not well understood by many users of financial statements in comparison with profit or loss, therefore increasing the use of OCI is not likely to benefit these users and, if the rationale for this approach is not clearly set out, it may increase confusion over the significance of amounts reported in OCI.

    (d) introducing another category of measurement effects in OCI without recycling would further impair the relevance of OCI as a performance measure.

    (e) impact on earnings per share (EPS) calculations.

    (f) implies that the underlying principles of classification may not be appropriate.

    (g) using OCI will create further mismatches from the holder's perspective under IFRS 9, where derivatives are measured at fair value though profit or loss and some debt instruments (held as financial assets) can be measured at fair value through OCI with recycling to profit or loss.

(h) the complexity and costs of disaggregating OCI for preparers are likely to exceed the expected benefits of the information for users of financial statements.

(i) the proposal might provide structuring opportunities (eg an entity may try to avoid presenting funding costs in profit or loss by structuring transactions such that the amount of the obligation is dependent on an entity's available economic resources).

(j) separate presentation in OCI would not always properly reflect the financial performance of financial instruments falling under the proposed scope. Income and expenses arising from some financial instruments may be actual economic gains or losses for the entity, specifically when financial instruments are settled in cash.

(k) a presentation of income and expenses in OCI would not provide more relevant information for trading derivatives that have net amounts that are unaffected by any independent variable.

(l) leads to an exception in presentation, replacing one rule with another rather than developing a principle-based outcome.

45. A few respondents suggested the Board further investigate the scope of the separate presentation requirements for financial liabilities because of the increased use of OCI in the statement of financial performance. They suggested the Board examine more types of instruments to clearly identify all the financial instruments which could be affected by the issuer's performance and could lead to counter-intuitive accounting under IFRS Standards for example, cash-settled share-based payment liabilities. A few respondents referred to the debate about whether changes in the carrying amount of NCI puts should be presented directly in equity as a transaction with shareholders and encouraged the Board to scope out such instruments from the accounting in OCI.

46. Some respondents questioned whether presentation in OCI is consistent with the principles on the use of OCI in paragraph 7.17 of the Conceptual Framework which states that the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in OCI when doing so would result in the statement of profit or loss

providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period. These respondents do not believe that the use of OCI in the presentation proposals amounts to such an exceptional circumstance and questioned whether extending the use of OCI for the financial instruments listed in paragraph 3 of this paper would make profit or loss more relevant.

47. These respondents also believe there is insufficient discussion in the DP on this conceptual matter. They recommended the Board provides a conceptual basis for the use of OCI and noted that the first step to develop founding principles for the dividing line between profit or loss and OCI should be a proper debate around the notion of performance. They also suggested separately discussing the pros and cons of allowing two co-existing types of OCI (recycling and non-recycling OCI) and believed the discussions contained in the DP are not sufficient on this point either.

48. Some respondents that disagreed with the presentation of income and expenses in OCI, recommended either separate presentation in profit or loss (see paragraphs 49-53) or disclosures in the notes (see paragraphs 54-55) as alternative approaches to enhance the information provided. They believe these alternatives are better than creating a further disconnect between profit or loss and the balance sheet.

*(i) Separate presentation in profit or loss*

49. Some respondents explicitly supported the presentation of income and expenses arising from financial instruments listed in paragraph 3 of this paper in a separate line item in profit or loss. These respondents believe the Board’s preferred approach increases complexity by requiring judgement of whether the amount is independent of the entity’s available economic resources or not and requiring such changes in OCI. They further believe:

   (a) if financial instruments have been properly classified as financial liabilities based on sound conceptual principles, then income and expenses arising on such liabilities should not be presented in OCI ie the accounting should follow 'standard' financial liability accounting. This follows the principle that the presentation of subsequent changes follows the classification.

(b) presentation in profit or loss would help users of financial statements make assessments of the impact of these instruments on an entity’s financial performance. The gains or losses on these financial instruments represent true economic gains or losses related to valid claims against the entity and therefore would be more appropriately presented in profit or loss.

50. Some respondents believe presentation in OCI is not an appropriate solution to the issues identified in the DP relating to presentation in profit or loss, ie the effect of non-operating items on financial performance. They highlighted the counter-intuitive accounting observed in some recent high-profile initial public offering (IPO) cases, where high-performing companies reported huge losses from fair valuing their derivative financial liabilities. An accounting firm recommends addressing this issue of counter-intuitive accounting by clear presentation in the statement of profit or loss, which shows how much profit or loss is dependent on changes in the fair value of an entity's own equity or an entity's earnings, and enhanced disclosures about key contractual terms and conditions of those financial instruments together with specific sensitivity analyses on the profit or loss impact.

51. Another argument respondents provided for disagreeing with the use of OCI, is that they do not believe recognising changes in the liability in profit or loss is counterintuitive. If an entity writes an option over its own equity that results in the instrument being measured at fair value, increases in the value of the entity’s equity will generate losses. They believe this faithfully represents a loss to the entity as the consideration it will receive on issuing equity is less than the fair value of equity delivered. They also believe changes in the fair value of an entity’s own equity is not similar to changes in the fair value of own credit because the basis for excluding changes in the fair value of own credit risk in profit or loss was the inability of the entity to realise the gain or loss. This is not the case for derivatives over own equity because in their view resources are either received or paid in exchange for the delivery or receipt of an equity instrument so the gain or loss will be realised.

52. They also believe that arrangements involving fair value puts or forwards where the strike or contracted forward price is equal to the fair value of the shares to be

delivered at the time of delivery are in substance liquidity contracts—rights or obligations for the holder to deliver shares back to the issuer for their then market price. In their view, other than the benefit for the holder to have liquidity in selling shares back to the issuer they do not have value (i.e. there is no intrinsic value). They believe such contracts should be fair valued through profit or loss, appropriately reflecting only the liquidity benefit, to the extent that there is any, to the holder and will not result in gains or losses arising from changes in the fair value of the issuer's equity instruments. A standard-setting body also said derivative instruments classified as financial liabilities should be revalued in profit or loss.

53. Respondents also commented that separating income and expenses and presenting them in OCI will give rise to fresh interpretation issues (see paragraph 56(f) discussing exercise prices based on a multiple of EBITDA). Their preference is therefore to keep all amounts within profit or loss but provide additional disclosures. They believe separate line item presentation is a good solution (albeit one that can already be achieved under IAS 1) which will both encourage comparability and provide a way of adding focus to situations that otherwise result in counter-intuitive accounting under IFRS.

*(ii) Disclosures in the notes to the financial statements*

54. A few respondents said that considering the challenges that would arise in practice from separately presenting such liabilities on the face of the primary financial statements and their objection to introducing new items in OCI, with or without subsequent reclassification, they would rather support providing additional information about the amount feature through disclosures in the notes to the financial statements. They believe that recognising additional items in OCI will add complexity for users of financial statements without creating benefits that could not also be achieved by additional disclosures.

55. Respondents further suggested that such disclosures could be restricted to liabilities, derivatives and embedded derivatives that are solely dependent on an entity's available economic resources.

### *Other issues*

56. Some respondents believe the separate presentation requirements will give rise to interpretation issues, with the potential for perceived or actual inconsistency. They highlighted the following other issues for the Board to consider:

    (a) Provision of sensitive information—for example an NCI put at fair value. If the shares of the subsidiary are not quoted in an active market, the liability is measured using a model with many unobservable inputs and the separate presentation of this liability could prejudice negotiations of the final price when the NCI put is exercised. They recommended the Board consider whether a different form of presentation such as merging the amounts with other kinds of liabilities and OCI reserves would be warranted, or a disclosure concession similar to the one in paragraph 92 of IAS 37 related to disputes with other parties.

    (b) Separate presentation for other types of liabilities—recommendation for separate presentation of financial liabilities that contain an obligation for an amount independent of the entity's available economic resources and which are settled by the transfer of own equity instruments for example, share-settled bonds since they are settled in the entity's own equity. An alternative recommendation is for the separate presentation of financial instruments (and related income and expense) which qualify as a liability because they contain an unavoidable obligation to pay an amount independent of the entity's economic resources only upon liquidation, for example cumulative perpetual preference shares.

    (c) Transaction costs—additional guidance and clarification to be provided on the accounting treatment of transaction costs incurred at the time of initial recognition of each of the three categories of financial instruments mentioned in paragraph 3 of this paper.

    (d) Impact on existing requirements in IFRS 9—it was noted that the presentation proposals could impact not only the use of OCI but also the separation of embedded derivatives in hybrids.

(e) Fair value option—the DP does not provide the option to designate a liability at fair value through profit or loss if the presentation in OCI would create or enlarge an accounting mismatch in profit or loss. Paragraph 5.7.8 of IFRS 9 provides such an option when requiring the change in fair value of a financial liability that is attributable to changes in credit risk to be presented in OCI. A preparer explained that in their business they have cases where liabilities with amounts dependent on the entity’s available economic resources are designated at fair value through profit or loss to eliminate or reduce an accounting mismatch with assets measured on this basis. More than one preparer explained that another accounting mismatch arises where a derivative over an index which includes the entity's own equity is economically hedged by a net cash-settled derivative on own equity. They said the former will be measured at fair value through profit or loss under IFRS 9 while the measurement changes on the latter will be presented in OCI under the DP, since it is a derivative on own equity with net amounts unaffected by any independent variable.

(f) Exercise price of NCI put based on EBITDA multiple—Some respondents highlighted that the strike price of an NCI put is often based on a multiple of a specific indicator (for example, EBIT, EBITDA or number of customers) when the subsidiary is not listed or a percentage of the fair value of the shares to be acquired. They said that from an accounting perspective, these strike prices are not considered equivalent to fair value so these redemption obligations will not be eligible for the separate presentation of income and expenses in OCI, unlike comparable transactions where the strike price is the fair value of the shares. They highlighted that for these instruments, the current contradictory and counterintuitive accounting in profit or loss will persist. Alternative approaches were suggested:

    (i) separate presentation of the changes in liabilities in a separate line item in profit or loss for both NCI puts at fair value and those based on a multiple of EBITDA, with additional disclosures (see paragraph 53).

(ii) recognising a gross liability for the fair value of the redemption obligation, with changes in the carrying amount recognised in OCI. They would then recognise a derivative at fair value through profit or loss for the difference between the fair value of the redemption obligation and the calculated exercise price of that redemption obligation, if any.

(g) Hedge accounting—it was noted that when the denomination in the foreign currency is imposed by an external factor (and the revaluation of the instrument is presented in non-recyclable OCI), it would be logical and normal for the issuer entity to decide to hedge its own exposure to foreign currency risk and such hedges should be eligible for hedge accounting. They believe IFRS 9 should be amended to allow such hedge accounting, even if, in that particular case, foreign currency exposure would never affect profit or loss. Others observed that recognising own equity amounts on a non-recyclable basis through OCI significantly impacts on the ability to hedge the volatility in OCI, unless the hedge accounting rules are amended. For example, this approach could potentially have a significant impact on net-cash-settled derivatives referencing own equity which are used to hedge cash-settled share-based compensation. The non-recyclable OCI treatment of the volatility would cause an accounting mismatch with the cash-settled share-based awards, either through an economic hedge or through a cash flow hedge.

(h) Interaction with other Board projects—A number of concerns were raised about the use of OCI (see paragraphs 44-48) and the no-recycling alternative without a thorough theoretical discussion of the reasoning, its definition and use. Some respondents suggested addressing this issue not on a standalone basis but as part of an overall assessment of the use of OCI and broader research on the conceptual grounds where to separate items between profit or loss and OCI. It was noted that OCI is on the agenda of the Board's Better Communication in Financial Reporting project and the need to co-ordinate the OCI proposals in both projects. They believe that the Primary Financial Statements project (in particular the performance reporting aspects) should be in a more advanced stage before the Board decides to expand the use of OCI. They also said it is important that any disclosures relating to capital instruments build on the principles developed in the Board's projects on Principles of Disclosure and Primary Financial Statements.

## Hybrid instruments

57. Many of the respondents that commented on Question 7 of the DP, provided feedback on the separation of embedded derivatives from hybrid instruments measured at fair value through profit or loss (applying the fair value option) for presentation purposes.

58. It was noted that the inclusion of such hybrid instruments in the scope of the separate presentation requirements may not be practicable, particularly if the entity is unable to measure the embedded derivative separately. Conversely, a scope exclusion would reduce comparability between embedded derivatives that are separated and those that are not separated from the host contracts.

59. A few respondents that did not support the requirements for separate presentation in OCI noted that they would not support either Alternative A or Alternative B as neither alternative provides useful information. However, if the Board decided to proceed with this proposal, they would prefer Alternative A. Others that did not support the separate presentation proposals said they would support Alternative A and suggested the Board considers providing the information within the notes.

### *Support for Alternative A*

60. Most respondents supported Alternative A as the more intuitive alternative. They objected to Alternative B (applying the separate presentation requirements to all embedded derivatives whether separated from the host contract or not) because in their view:

    (a) the separation process would be too complex.

    (b) the effort and costs to preparers of providing such information would outweigh any benefits to users of the financial statements.

(c) it negates the fair value option and undermines the benefit of accounting for the entire hybrid instrument at fair value through profit or loss. These respondents said the key reasons they apply the fair value option for the hybrid instrument are that in some cases, obtaining a reliable measurement of the embedded derivative may be too judgmental from a valuation perspective, and bifurcation of embedded derivatives is generally a costly exercise.

(d) the separate presentation and disclosure of embedded derivatives and host contracts would be confusing and provide little benefit to users of financial statements because for recognition and measurement purposes these embedded derivatives are not separated from the host contract.

61. A few respondents are supportive of providing additional narrative disclosures regarding the embedded derivative which is not separated from the hybrid contract for measurement or presentation purposes. Although, it was acknowledged that the proposed disclosure requirements in the DP would sufficiently enable users of financial statements to understand these types of instruments.

### *Support for Alternative B*

62. A few respondents supported Alternative B for the following reasons:

(a) it improves comparability because the proposals will be applied to standalone and embedded derivatives (whether separated or not from the host contract) in the same way.

(b) it should not be difficult to separate the embedded derivative because the underlying variables would be restricted to own equity prices and, in certain cases, foreign exchange rates (ie the exception to present income and expenses in OCI would be narrowly defined).

(c) this proposed presentation would better reflect to users of financial statements what component of the hybrid instrument is associated with the related OCI income or expenses presented.

(d) IFRS 9 requires changes in fair value due to own credit risk for a financial liability designated at fair value through profit or loss to be recorded in OCI. It would therefore make sense to extend similar accounting to any non-separated embedded derivatives on the entity s shares, if the embedded derivative contains no obligation for an amount independent of the entity’s available economic resources.

63. A few respondents believe Alternative B should be applied, unless an entity determines that doing so would be impracticable. They said if an entity was unable to measure the embedded derivative separately it should present the entire hybrid instrument at fair value through profit or loss with disclosures about this fact to allow users of financial statements to understand the impact.