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STAFF PAPER

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Project	Primary Financial Statements
Paper topic	Classification of exchange differences and gains and losses on derivatives in the statement(s) of financial performance

CONTACT(S)	Umair Shahid	ushahid@ifrs.org	+44 (0) 20 7246 6414
	Nick Barlow	nbarlow@ifrs.org	+44 (0) 20 7246 6499
	Karlien Conings	kconings@ifrs.org	+44 (0) 20 7246 6913
	Aida Vatrenjak	avatrenjak@ifrs.org	+44 (0) 20 7246 6456

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Purpose of the paper

1. The purpose of this paper is to clarify the classification in the sections of the statement(s) of financial performance (operating, investing or financing) of:
   (a) exchange differences included in profit or loss applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*;
   (b) gains and losses on derivatives, included in profit or loss; and
   (c) gains and losses on non-derivative financial instruments used for risk management, included in profit of loss.
2. This paper does not discuss:
   (a) the recognition or measurement of such income and expenses;
   (b) the classification of such income or expenses that are required to be included in other comprehensive income; or
   (c) in which line item in the statement(s) of financial performance such income and expenses should be included.

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Summary of staff recommendations

3. The staff recommend the Board:

   (a) clarify that an entity is required to classify exchange differences included in profit or loss applying IAS 21 in the same sections as the income and expenses from the activities to which they relate, in accordance with the Board's definitions for the sections.

   (b) require an entity to classify gains and losses included in profit or loss on a financial instrument designated as hedging instruments in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* (derivative and non-derivative financial instruments):

      (i) in the operating section, if the instrument is used to manage risks relating to the entity's main business activities—except when it would require grossing up of gains and losses;

      (ii) in the financing section, if the instrument is used to manage risks relating to the entity's financing activities—except when it would require grossing up of gains and losses; or

      (iii) in the investing section in all other cases—including when (i) and (ii) would require grossing up of gains and losses.

   (c) require an entity to also apply (b) to gains and losses included in profit or loss on a non-designated derivative—except when such a classification would involve undue cost or effort. In such cases, an entity may classify gains and losses on the derivative in the investing section.

   (d) clarify that an entity is required to classify gains and losses included in profit or loss on a non-designated non-derivative financial instrument in accordance with the Board's definitions for the sections.

Structure of paper

4. This paper is structured as follows:

   (a) Background (paragraphs 5–9)

   (b) Issue 1—classification of exchange differences (paragraphs 10–16)

   (c) Issue 2—classification of fair value gains and losses on derivatives (paragraphs 17–40)

   (d) Issue 3—classification of gains and losses on non-derivative financial instruments used for risk management (paragraphs 41–47)

   (e) Appendix A—Rejected Approach: Accounting policy choice for classification of fair value gains and losses on derivatives

   (f) Appendix B—Extracts from IFRS 9

   (g) Appendix C— Relevant extracts from tentative Board decisions

   (h) Appendix D—Analysis of current practice

Background

What is the issue?

5. The Board has tentatively decided to define and require subtotals in the statement(s) of financial performance, thereby creating three distinct sections—operating, investing and financing.

6. Stakeholders have indicated during outreach—including the November 2018 Global Preparers Forum[1] and the July 2017 Accounting Standards Advisory Forum[2]—that the classification into sections of the statement(s) of financial performance is potentially unclear for:

[1] See November 2018 GPF meeting summary.

[2] See July 2017 ASAF meeting summary.

(a) **Issue 1—**exchange differences arising from translating foreign currency items into an entity's functional currency. For the purpose of this paper we mean those exchange differences included in profit or loss in accordance with paragraphs 28 and 30 of IAS 21. For example this includes exchange differences on trade payables, trade receivables and borrowings denominated in a foreign currency.

(b) **Issue 2—**fair value gains and losses included in profit or loss on derivatives: [3]

(i) in a designated hedging relationship to which hedge accounting is applied ('designated derivatives') in accordance with IAS 39 or IFRS 9; and

(ii) not in a designated hedging relationship ('non-designated derivatives')—this includes derivatives held for risk management purposes to which hedge accounting is not applied (either because the entity has chosen not to, or the qualifying criteria are not met) and derivatives held for other purposes.

(c) **Issue 3—**gains and losses on non-derivative financial instruments (designated[4] and non-designated) used for risk management.

7. The following table summarises the scope of Issues 2 and 3:

[3] See Appendix B for the IFRS 9 definition of a 'derivative'. Fair value gains and losses include the effective and ineffective portion.

[4] Paragraph 6.2.2 of IFRS 9 describes which non-derivative financial instruments are qualifying hedging instruments.

		Gains or losses on:	
		Derivatives	Non-derivative financial instruments
Used for risk management	Designated	Issue 2	Issue 3
	Not designated	Issue 2	Issue 3
Not used for risk management		Issue 2	(Not relevant)[5]

Existing requirements in IFRS Standards

8. IFRS Standards have few requirements regarding the presentation in the statement(s) of financial performance of the income and expenses listed in paragraph 6:

   (a) IAS 21 does not specify where to present exchange differences included in profit or loss in the statement(s) of financial performance.

   (b) paragraph 78 of IAS 12 *Income Taxes* states that exchange differences on deferred foreign tax liabilities or assets may be classified as 'deferred tax expense (income)' if that presentation is considered to be the most useful to financial statement users.

   (c) IFRS 9 contains presentation guidance for hedges of a group of items only (see paragraphs 6.6.4 and B6.6.13–B6.6.16 of IFRS 9 included in Appendix B).

   (d) the IFRS Interpretations Committee March 2018 agenda decision explains that: 'the requirement in paragraph 82(a) of IAS 1 to present separately an interest revenue line item calculated using the effective interest method applies only to those assets that are subsequently measured at amortised cost or fair value through other comprehensive income (subject to any effect of a qualifying hedging relationship applying the hedge accounting requirements in IFRS 9 or IAS 39)'. This confirmed that fair value gains

[5] We think classification applying the Board's definitions for the sections is clear in such cases.

and losses on non-designated derivatives cannot be included in that line item.

9. Appendix D summarises classification observed in practice—including diversity in classification for the ineffective portion of fair value gains and losses on designated derivatives in a cash flow hedge and the fair value gains and losses on non-designated derivatives.

Issue 1—classification of exchange differences

10. This section discusses classification of exchange differences in the scope of IAS 21, arising from translating foreign currency items into an entity's functional currency. The scope of IAS 21 excludes:

    (a) derivative transactions and balances that are in the scope of IFRS 9 (see paragraph 3(a) of IAS 21); and

    (b) hedge accounting for foreign currency items (see paragraph 5 of IAS 21).

11. The discussion in this section does not relate to the classification of exchange differences arising on translation of a foreign operation.

Applying the Board's tentative decisions

12. In our view, applying the tentative Board decisions to exchange differences is relatively straightforward—for non-financial entities:

    (a) exchange differences related to financing activities are classified in the financing section, because they are captured by the definition of 'financing activities' (see Appendix C). For example, this would include exchange differences on debt denominated in a foreign currency.

    (b) exchange differences on cash and cash equivalents are classified in the financing section, because they are captured as 'income and expenses from cash and cash equivalents' (see Appendix C).

(c) exchange differences on investments are classified in the investing section, because they are captured by the definition of 'income or expenses from investments' (see Appendix C).

(d) other exchange differences are classified in the operating section, because applying the Board's tentative decisions any income or expenses that are not required to be classified as investing or financing should be classified as operating.

13. Applying the Board's tentative decisions for financial entities: [6]

(a) (part of) the exchange differences in paragraphs 12(a) and 12(b) would be classified in the operating section if the entity provides financing to customers as a main business activity;[7]

(b) the exchange differences in paragraph 12(b) would be classified in the operating section if the entity invests in financial assets as a main business activity;[8] and

(c) the exchange differences in paragraph 12(c) would be classified in the operating section to the extent they relate to investments made in the course of the entity's main business activity.[9]

14. However, we understand some stakeholders have concerns about the classification applying the Board's tentative decisions for non-financial entities:

(a) it may be costly for some entities to track whether exchange differences relate to the entity's main business activities, investing activities or financing activities. In particular when foreign currency risk is managed by a centralised treasury department on a net basis, an entity's accounting systems may not retain information about the transactions or items that gave rise to exchange differences.

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[6] Refer to the cover note for a summary of the Board's tentative decisions. Also see AP21A for the February 2019 Board meeting and AP21B for the April 2019 Board meeting.

[7] See paragraph 16(a) in the Appendix of the cover note.

[8] See paragraph 16(c) in the Appendix of the cover note.

[9] See paragraph 16(b) in the Appendix of the cover note.

(b) exchange differences are often volatile and are, arguably, outside of management's control. Therefore, some entities want to present exchange differences outside operating profit. Some entities choose to present alternative performance measures on a constant-currency basis for this reason.

(c) the benefits to users of this approach may not be enough to justify the cost. Some users[10] have said classification in the statement(s) of financial performance cannot provide the detail they need to understand the effect of foreign currency risk or linkages between foreign currency items in different sections—such information can only be provided in a note disclosure.

15. Despite the concerns expressed in paragraph 14, we recommend the Board should *not* amend the application of its proposals for exchange differences because the application described in paragraphs 12 and 13:

(a) contributes to the Board's defined subtotals providing a faithful representation of an entity's main business activities, investing activities and financing activities. For example, in our view, stripping out exchange differences related to an entity's main business activities from operating profit (see paragraph 14(b)) and classifying them in a different section would result in operating profit providing an incomplete picture of the entity's main business activities.

(b) is similar to many entities' current practice (see paragraph D2(a) of Appendix D).

16. However, we recommend:

(a) clarifying the application of the tentative Board decisions to exchange differences in Application Guidance—along the lines of paragraphs 12 and 13;

[10] See the Corporate Reporting Users' Forum comment letter in response to a similar proposal in the Discussion Paper *Preliminary Views on Financial Statement Presentation*.

(b) including a discussion of the potential costs described in paragraph 14(a) in the effects analysis accompanying the exposure draft; and

(c) further exploring the feasibility of the proposals in outreach after publishing the exposure draft.

Question 1—Exchange differences
Does the Board agree with the staff recommendation to clarify that an entity shall classify exchange differences included in profit or loss applying IAS 21 in the same sections of the statement(s) of financial performance as the income and expenses from the activities to which they relate, in accordance with the Board's definitions for the sections?

Issue 2—Classification of fair value gains and losses on derivatives

Applying the Board's tentative decisions

17. Applying the tentative Board decisions to derivatives:

(a) fair value gains and losses on derivatives would *not* be captured by the definition of 'financing activities' in Appendix C.

(b) it is unclear whether fair value gains and losses on any derivatives meet the definition of 'income or expenses from investments' in Appendix C, because:

(i) it is unclear whether derivatives are 'assets that *generate a return*', because derivatives may not require any initial net investment[11] and may result in a cash outflow rather than a return for the entity.

(ii) it is unclear whether derivatives 'generate a return *individually and largely independently* of other resources held by the

[11] See definition of derivatives in Appendix B.

entity'. It could be argued that derivatives used for risk management do not meet this definition, because there is a link between the derivative and the assets or liabilities affected by the risk that is being managed. However, it can also be argued that the amount of fair value gains and losses on a derivative is not affected by the entity's activities or by the use of the derivative in the entity's activities. Therefore, derivatives always generate returns independently of the other resources of the entity.

(iii) the definition of 'income and expenses from investments' refers only to assets, whereas derivatives could be assets or liabilities.

(c) fair value gains and losses on derivatives that do not meet the definition of 'income and expenses from investments' would be classified in the operating section.

18. Consequently, the application of the Board's tentative decisions:

(a) would mean fair value gains and losses on derivatives that are used for risk management are not necessarily classified in the section of the statement(s) of financial performance that is affected by the risk the entity intends to manage. For example, fair value gains and losses on derivatives used to manage interest rate risk on financing activities would not be presented in the financing section applying the Board's tentative decisions.

(b) may lead to diversity in practice, due to different interpretations of the requirements.

19. We think the Board should supplement its tentative decisions with classification requirements for fair value gains and losses on derivatives to address the issues in paragraph 18. In developing such requirements, we think the Board should pursue the following objectives:

(a) achieving classification outcomes that result in the Board's defined subtotals providing a *faithful representation* of an entity's main business activities, investing activities and financing activities. In our view, this generally means that the classification needs to reflect an entity's risk management activities.

(b) enhancing *comparability* of the Board's defined subtotals between different entities. In developing its proposals for defined subtotals, the Board has so far tried to avoid classification options. We note that comparability is not the same as consistency or uniformity (see paragraphs 2.26–2.27 of the *Conceptual Framework for Financial Reporting*).

20. We have identified two possible approaches for the Board to consider for the classification of fair value gains and losses on derivatives:

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Fair value gains and losses on derivatives:</th></tr>
<tr><th>Approach A
(paragraphs 22–32)</th><th>Approach B
(paragraphs 33–39)</th></tr>
<tr><td rowspan="2">Used for risk management</td><td>Designated</td><td>Classify in the section affected by the hedged item, except when it would involve grossing up gains and losses—then classify in the investing section</td><td>Classify in the section affected by the risk the entity intends to manage, except when it would involve grossing up gains and losses—then classify in the investing section</td></tr>
<tr><td>Not designated</td><td rowspan="2">Classify in the investing section</td><td>Classify as described above except if such classification would involve undue cost or effort—then classification in the investing section is allowed</td></tr>
<tr><td colspan="2">Not used for risk management</td><td>Classify in the investing section</td></tr>
</table>

21. We considered, but rejected requiring entities to develop an accounting policy for classification of fair value gains and losses on derivatives (see analysis in paragraphs A1–A3 of Appendix A).

Approach A—Reflecting risk management for designated derivatives, classification in the investing section in other cases

Description of Approach A—non-designated derivatives

22. Approach A would require an entity to classify fair value gains and losses on non-designated derivatives in a *single section*.

23. We think the single section should be the investing section because, as discussed in paragraph 17(b)(ii), fair value gains and losses on non-designated derivatives can be viewed as meeting the definition of 'income and expenses from investments'—they generate income and expenses largely independently from the other resources of the entity.

24. If a financial entity holds non-designated derivatives in the course of its main business activities, gains and losses on such derivatives would be included in the operating section applying the Board's tentative decisions for financial entities.[12]

Description of Approach A—designated derivatives

25. Approach A would require an entity to classify fair value gains and losses on a designated derivative—both the effective and the ineffective portion[13]—in the section affected by the hedged item. We think in most cases, application should be straightforward, given that entities are required to document designated hedging relationships.

26. This approach would be consistent with:

    (a) entities' current practice of presenting the effective portion of gains and losses on designated hedging instruments in the line item(s) affected by the hedged item(s) (see paragraph D3 of Appendix D). This practice could be seen as consistent with the objective of hedge accounting (see paragraph 6.1.1 of IFRS 9).

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[12] See paragraph 16(b) in the Appendix of the cover note.

[13] The ineffective portion will be relatively small for designated derivatives because of the hedge effectiveness requirements in IFRS 9. We also note entities would be able to include the effective and ineffective portion in different line items within the same section.

(b) paragraph B6.6.14 of IFRS 9 which requires that, when a hedging instrument hedges a group of items with non-offsetting risk positions, the reclassified fair value gains and losses on the hedging instrument shall be apportioned to the line items affected by the hedged items.

Description of Approach A—special case of designated hedges of groups of items with offsetting risk positions

27. When a hedging instrument hedges a group of items with offsetting risk positions, paragraph 6.6.4 and B6.6.15 of IFRS 9 require fair value gains and losses on the hedging instrument to be presented in a separate line item, rather than being included in the line items affected by the hedged items. Paragraphs BC6.456–BC6.461 of the Basis for Conclusions on IFRS 9 explain that the Board's rationale for this requirement was to avoid entities grossing up gains and losses from a single hedging instrument in such cases.

28. If, for a designated derivative in the circumstances described in paragraph 27:

(a) the line items affected by the hedged items are included in a *single* section of the statement(s) of financial performance, applying the proposal in paragraph 25 would require an entity to classify the fair value gains and losses on the derivative in that section.

(b) the line items affected by the hedged items are included in *multiple* sections, applying the proposal in paragraph 25 would require grossing up of the fair value gains and losses on the derivative. This would conflict with the Board's rationale explained in paragraph 27.

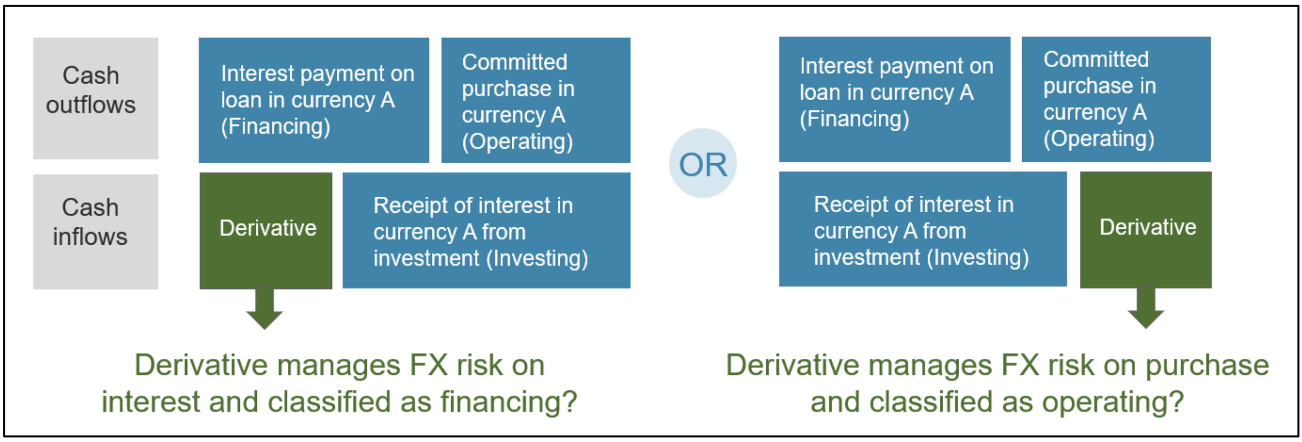
29. Therefore, in Approach A, the principle in paragraph 25 does not apply to cases described in paragraph 28(b). Instead, in Approach A an entity should classify fair value gains and losses on designated derivatives in such cases in a single section. We think the single section should be the investing section[14] because, as discussed in paragraph 17(b)(ii), fair value gains and losses on derivatives can be viewed as meeting the definition of 'income and expenses from investments'.

[14] Application to financial entities would be similar to paragraph 23.

30. We have not considered allowing entities to develop an accounting policy for the classification of the gains and losses described in paragraph 29 because:

(a) it would not achieve consistency across entities, which could arguably impair comparability (see objective in paragraph 19(b)); and

(b) in some cases it may be difficult for an entity to develop an accounting policy that achieves a faithful representation of its activities. For example in the case illustrated below, an entity would need to make an arbitrary classification choice.



Advantages and disadvantages of Approach A

31. The advantages of this approach are that:

(a) it could be argued the classification outcome applying this approach faithfully represents the entity's risk management activities if it designates the derivatives it uses for risk management (ie it could be argued the 'faithful representation' objective in paragraph 19(a) would be met for designated derivatives);

(b) it would arguably contribute to comparability (see objective in paragraph 19(b)) as different entities would:

(i) consistently classify fair value gains and losses on designated derivatives; and

(ii) consistently classify fair value gains and losses on non-designated derivatives; and

(c) it is easy to apply for preparers.

32. The disadvantages of this approach are that:

(a) the classification outcome would not reflect an entity's risk management activities if it does not designate the derivatives it uses for risk management. Therefore, it could be argued the 'faithful representation' objective in paragraph 19(a) would not be met for non-designated derivatives.

(b) the classification for a particular derivative depends on whether an entity chooses to apply hedge accounting to it. It could be argued this is counterintuitive.

Approach B—Reflecting risk management for all derivatives, classification in the investing section in other cases

Description of Approach B

33. The starting point for this approach is that an entity shall classify gains and losses on:

(a) *all* derivatives used for risk management (designated and non-designated) in the section affected by the risk managed using the derivatives; and

(b) derivatives not used for risk management in the investing section.

34. However:

(a) similar to Approach A (see paragraphs 27–30), we think the principle in paragraph 33(a) should not be applied in cases where it would require grossing up of gains and losses. For designated derivatives, this would be prohibited by the requirements in paragraph B6.6.14 of IFRS 9 (see paragraph 27).

(b) we think identifying the section(s) affected by the risk(s) managed using non-designated derivatives may involve undue cost or effort—for example this may be the case when risks are managed by a central treasury department. In such cases, we think relief should be provided by allowing entities to present gains and losses in the investing category.

35. Approach B can be formulated as follows, combining paragraphs 33 and 34: An entity shall classify fair value gains and losses included in profit or loss on:

(a) a designated derivative:

(i) in the operating section, if the derivative is used to manage risks relating to the entity's main business activities—except when it would require grossing up of gains and losses;

(ii) in the financing section, if the derivative is used to manage risks relating to the entity's financing activities—except when it would require grossing up of gains and losses; or

(iii) in the investing section in all other cases—including when (i) and (ii) would require grossing up of gains and losses.

(b) a non-designated derivative as described in (a)—except when such a classification would involve undue cost or effort. In such cases, an entity may classify gains and losses on the derivative in the investing section.

36. We note that:

(a) as paragraph 35(a)(i) refers to an entity's 'main business activities', derivatives held by financial entities to manage risks relating to their main business activities will be classified in the operating section. If a financial entity holds derivatives for trading purposes in the course of its main business activities, gains and losses on such derivatives would be included in the operating section applying the Board's tentative decisions for financial entities.[15]

(b) the qualifying criteria for hedge accounting (see paragraph 6.4.1(c) of IFRS 9), including hedge effectiveness, may not be met for non-designated derivatives used for risk management. In such cases the 'ineffective' portion—though an entity is not required to identify that portion—of the gains and losses on the derivatives may be significant. Applying Approach

[15] See paragraph 16(b) in the Appendix of the cover note.

B, the gain or loss (including the effective and ineffective portion) would be classified in the section affected by the risk the entity intends to manage. It could be argued this is appropriate because both the effective and ineffective portion arise as a result of the entity managing risks related to its main business activities, investing activities or financing activities.

(c) like Approach A (see paragraph 26), Approach B is consistent with the requirements of IFRS 9 and entities' current practice for designated derivatives.

Advantages and disadvantages of Approach B

37. The advantages of this approach are that:

(a) it could be argued the classification outcome applying this approach faithfully represents the entity's risk management activities using both designated and non-designated derivatives (ie it could be argued the 'faithful representation' objective in paragraph 19(a) would be met).

(b) the same classification treatment applies to designated and non-designated derivatives used for risk management—it could be argued this is appropriate considering hedge accounting is optional.

38. However, the disadvantages of this approach are:

(a) the application to non-designated derivatives may be costly because for each non-designated derivative an entity would need to:

(i) identify the section(s) affected by the risk(s) managed using the derivative; and

(ii) monitor whether the reason the entity is holding the derivative has changed.

(b) applying the approach to non-designated derivatives may involve significant judgement—particularly for those that do not meet the qualifying criteria for hedge accounting. Consequently, there may be a risk of inconsistent application for non-designated derivatives.

39. We note that, while Approach B would treat designated and non-designated derivatives in the same way for classification purposes, there are still differences between applying hedge accounting and not applying hedge accounting:

    (a) only hedge accounting provides an exception from the normal recognition and measurement requirements in IFRS Standards, which allows an entity to avoid volatility in profit or loss.

    (b) as explained in the IFRS Interpretations Committee Agenda Decision described in paragraph 8(d), presenting fair value gains and losses on derivatives in the line item 'interest revenue calculated using the effective interest method' is only allowed for designated derivatives.

Staff recommendation

40. The staff recommend Approach B because the classification outcome applying Approach B reflects an entity's risk management activities, regardless of whether the entity applies hedge accounting, which in our view contributes to a faithful representation of the entity's activities.

Question 2—Fair value gains and losses on derivatives
Does the Board agree with the staff recommendation to require an entity to: (a) classify fair value gains and losses included in profit or loss on a designated derivative: (i) in the operating section, if the derivative is used to manage risks relating to the entity's main business activities—except when it would require grossing up of gains and losses; (ii) in the financing section, if the derivative is used to manage risks relating to the entity's financing activities—except when it would require grossing up of gains and losses; or

(iii) in the investing section in all other cases—including when (i) and (ii) would require grossing up of gains and losses.

(b) also apply (a) to fair value gains and losses on a non-designated derivative—except when such a classification would involve undue cost or effort. In such cases, an entity may classify gains and losses on the derivative in the investing section?

Issue 3—Classification of gains and losses on non-derivative financial instruments used for risk management

41. Entities also use non-derivative financial instruments (designated[16] or non-designated) to manage risks. For example, an entity may use foreign currency borrowings to manage currency risk arising from future foreign currency sales with a similar maturity and amount. However, in our view, the primary purpose of such non-derivative financial instruments is usually not risk management. For example, in the case of foreign currency borrowings, the primary purpose is usually to provide the entity with capital—risk management is a secondary consideration.

42. Non-derivative financial instruments are different from derivatives in that:

(a) for derivatives we concluded that the classification of fair value gains and losses may not be clear applying the Board's tentative definitions for the sections (see paragraph 17).

(b) for non-derivative financial instruments, we think that the classification of gains and losses (fair value gains and losses and exchange differences) applying the Board's definitions for the sections is usually clear, in line with the entity's primary purpose for holding the instrument. Applying the

[16] Paragraph 6.2.2 of IFRS 9 describes which non-derivative financial instruments are qualifying hedging instruments.

Board's tentative definitions for the sections to the example in paragraph 41, exchange differences on borrowings would be classified in the financing section (by non-financial entities).

43. The classification outcome using the Board's tentative definitions for the sections as described in paragraph 42(b) would not reflect the entity's risk management activities using non-derivative financial instruments. For designated non-derivative financial instruments, it would be a change in practice for those entities that include fair value gains and losses on such instruments in the line item affected by the hedged item, potentially reducing the advantages of hedge accounting (see paragraph D3 of Appendix D).

44. Consequently, we think the Board should consider amending its tentative decisions for the classification of gains and losses on non-derivative financial instruments. We have identified two approaches for the Board to consider:

(a) require entities to use the approach for derivatives (ie Approach B in paragraph 35) to classify gains and losses on *all* non-derivative financial instruments used for risk management; or

(b) require entities to:

(i) apply the Board's definitions for the sections to gains and losses on *non-designated* non-derivative financial instruments as described in paragraph 42(b); and

(ii) classify gains and losses on *designated* non-derivative financial instruments using the approach for derivatives.

Staff recommendation

45. We recommend the approach described in paragraph 44(b) rather than the approach in paragraph 44(a) because:

(a) the approach in paragraph 44(b) reflects the primary purpose for which entities hold their non-derivative financial instruments.

(b) as described in paragraph 38(b), the classification approach proposed for derivatives (ie Approach B) may involve significant judgement for non-designated derivatives. We think widening the scope of this approach to *all* financial instruments used for risk management would:

(i) give entities significant flexibility in classifying gains and losses on all financial instruments (without the constraints of a designated hedging relationship). The Board could consider providing further guidance on what is considered ‘risk management’ and whether or how an entity should identify the portion of the gains or losses on a non-derivative financial instrument that relates to risk management. However, we think it would be difficult for the Board to provide such guidance.

(ii) result in significant costs for entities who would be required to assess the purpose of each of their non-derivative financial instruments.

46. The following table summarises the staff recommendations for Issues 2 and 3:

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Gains and 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>Designated</td><td colspan="2">Classify in the section affected by the risk the entity intends to manage, except when it would involve grossing up gains and losses—then classify in the investing section.</td></tr>
<tr><td>Not designated</td><td>Classify as described above except if such classification would involve undue cost or effort——then classification in the investing section is allowed</td><td>Apply Board’s definitions for sections</td></tr>
<tr><td colspan="2">Not used for risk management</td><td>Classify in the investing section</td><td>(not relevant)</td></tr>
</table>

Question 3— Non-derivative financial instruments used for risk management

Does the Board agree with the staff recommendation to:

(a) require an entity to classify gains and losses included in profit or loss on a designated non-derivative financial instrument:

  (i) in the operating section, if the instrument is used to manage risks relating to the entity's main business activities—except when it would involve grossing up of gains and losses;

  (ii) in the financing section, if the instrument is used to manage risks relating to the entity's financing activities—except when it would involve grossing up of gains and losses; or

  (iii) in the investing section in all other cases—including when (i) and (ii) would involve grossing up of gains and losses.

(b) clarify that an entity shall classify gains and losses on a non-designated non-derivative financial instrument applying the Board's definitions for the sections?

47. Note that paragraph (a) of Question 3 has been combined with the staff recommendation for designated derivatives in the summary of staff recommendations in paragraph 3(b).

Appendix A—Rejected Approach: Accounting policy choice for classification of fair value gains and losses on derivatives

A1. This approach would require an entity to develop its own accounting policy in accordance with paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

A2. The advantages of this approach are:

(a) the Board would not need to provide detailed guidance.

(b) existing requirements in IFRS Standards for accounting policies would provide some discipline:

(i) paragraph 10 of IAS 8 requires accounting policies to result in information that is relevant and represents faithfully the financial position, financial performance and cash flows of the entity;

(ii) paragraph 13 of IAS 8 requires an entity to apply its accounting policies consistently to similar transactions;

(iii) paragraph 14 of IAS 8 restricts an entity's ability to change its accounting policies over time; and

(iv) paragraph 117 of IAS 1 requires an entity to disclose its significant[17] accounting policies.

A3. However, we have rejected this approach because we think this approach would not meet the 'comparability' objective in paragraph 19(b), as entities may have different views on how to achieve a faithful representation—for example:

(a) one entity might include in operating profit fair value gains and losses on non-designated derivatives used to manage risks relating to its main business activities; whereas

[17] The Board is developing amendments to paragraphs 117–124 of IAS 1 to require entities to disclose their material accounting policies rather than their significant accounting policies.

(b) another entity might present such gains and losses outside operating profit, because it argues such gains and losses are volatile and result from a measurement mismatch, rather than actual risk exposure.

Appendix B—Extracts from IFRS 9

Definition of a derivative (Appendix A of IFRS 9)

A financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date.

Presentation requirements in IFRS 9 for hedges of a group of items

6.6.4 For a hedge of a group of items with offsetting risk positions (ie in a hedge of a net position) whose hedged risk affects different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses in that statement shall be presented in a separate line from those affected by the hedged items. Hence, in that statement the amount in the line item that relates to the hedged item itself (for example, revenue or cost of sales) remains unaffected.

B6.6.13 If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of profit or loss and other comprehensive income. The presentation of hedging gains or losses in that statement depends on the group of items.

B6.6.14 If the group of items does not have any offsetting risk positions (for example, a group of foreign currency expenses that affect different line items in the statement of profit or loss and other comprehensive income that are hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment shall be done on a systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument.

B6.6.15 If the group of items does have offsetting risk positions (for example, a group of sales and expenses denominated in a foreign currency hedged together for foreign currency risk) then an entity shall present the hedging gains or losses in a separate line item in the statement of profit or loss and other comprehensive income. Consider, for example, a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency expenses of FC80 using a forward exchange contract for FC20. The gain or loss on the forward exchange contract that is reclassified from the cash flow hedge reserve to profit or loss (when the net position affects profit or loss) shall be presented in a separate line item from the hedged sales and expenses. Moreover, if the sales occur in an earlier period than the expenses, the sales revenue is still measured at the spot exchange rate in accordance with IAS 21. The related hedging gain or loss is presented in a separate line item, so that profit or loss reflects the effect of hedging the net position, with a corresponding adjustment to the cash flow hedge reserve. When the hedged expenses affect profit or loss in a later period, the hedging gain or loss previously recognised in the cash flow hedge reserve on the sales is reclassified to profit or loss and presented as a separate line item from those that include the hedged expenses, which are measured at the spot exchange rate in accordance with IAS 21.

B6.6.16 For some types of fair value hedges, the objective of the hedge is not primarily to offset the fair value change of the hedged item but instead to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed-rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in profit or loss. In the case of a hedge of a net position (for example, a net position of a fixed-rate asset and a fixed-rate liability), this net interest accrual must be presented in a separate line item in the statement of profit or loss and other comprehensive income. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising them in different line items (for example, this avoids grossing up a net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense).

Appendix C—Relevant extracts from tentative Board decisions

Investing section	Income or expenses from assets that generate a return individually and largely independently of other resources held by the entity
Financing section	An entity shall present between the 'profit before financing and income tax' subtotal and the 'profit or loss' subtotal: (a) income from cash, and cash equivalents; (b) expenses (income) from financing activities; (c) interest expenses on liabilities that do not arise from financing activities; and (d) income tax income or expense. Financing activities involve the receipt or use of a resource from a provider of finance (or provision of credit) with the expectation that: (a) the resource will be returned to the provider of finance; and (b) the provider of finance will be appropriately compensated through the payment of a finance charge that is dependent on both the amount of the credit and its duration.

Appendix D—Analysis of current practice

D1. Although IFRS Standards do not currently require separate operating, investing and financing sections in the statement(s) of financial performance, many (non-financial) entities present an operating and a financing section.

D2. In a sample of financial statements of 25 non-financial entities we found that:

(a) most entities split exchange differences between operating and financing. Some entities classify all exchange differences in financing.

(b) there is diversity in where entities classify the ineffective portion for designated derivatives—many classify it in financing.

(c) there is diversity in where entities classify the fair value gains and losses for non-designated derivatives:

(i) many entities classify all such gains and losses in financing;

(ii) some entities split such gains and losses between operating and financing;

(iii) some entities classify all such gains and losses in operating; and

(iv) some entities do not disclose where they classify such gains and losses.

D3. Based on guidance published by audit firms, we understand that, for designated hedging instruments, it is common practice to include the effective portion in the line item affected by the hedged item. However, this was not clear from most entities' accounting policies in the sample.