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Project **IAS 39 *Financial Instruments: Recognition and Measurement***

Topic

Negative interest rates: implications for presentation in the statement of comprehensive income

Introduction

1. Historically, negative interest rates have been a rare phenomenon. However, against the background of the economic crisis the demand of investors for 'safe harbour' assets has increased to a degree that the yield on some assets (on some of the remaining high quality government bonds) has turned negative.

2. Although the interest rates are only slightly negative and this phenomenon applies only to few assets it raises the question of how the income or expense that results from negative interest rates should be presented in the statement of comprehensive income[1]. The staff have not (yet) received a formal submission on this issue but there have already been informal enquires. In the staff's view the reason for not receiving a formal submission so far is probably that the amounts involved are immaterial until now (given it is a recent phenomenon and would take more substantial investments to build up while yields are negative).

[1] In this paper the references to "statement of comprehensive income" refer to the profit or loss section of the statement of profit or loss and other comprehensive income or the separate statement of profit or loss (as applicable depending on an entity's choice under IAS 1 *Presentation of Financial Statements*).

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

3. However, the staff think that it is worth considering whether action should be taken before divergence in practice develops[2] and the amounts might become material. Therefore the staff bring this issue to the Committee now.

Objective

4. The objective of this paper is:

(a) to provide an analysis how the economic phenomenon of negative interest rates relates to IFRS requirements; and

(b) ask the Committee for its view.

Staff analysis

The economic phenomenon

5. A negative interest rate raises an obvious question: what is an investor's rationale for acquiring the asset? On the face of it, doing so means an investor will surely lose money by holding the investment. Even with an expectation of deflation that is (in absolute terms) higher than the negative interest rate it would not make sense to invest in assets with a negative interest rate because holding cash at no interest would be more profitable. Acquiring such an asset would only make sense with the objective of trading when speculating on an even lower, ie more negative, interest rate.[3]

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[2] The staff's informal outreach with some audit firms indicates that divergence might develop, or that the accounting for positive interest rates might 'automatically' be applied to negative ones.
[3] But the fact that negative interest rates occur in the shorter term maturities (up to two years) suggests that trading is not the main driver of the development (longer maturities provide better leverage for that purpose, in particular as the further downside for negative interest rates is naturally limited).

6. However, that applies only on the face of it—that perspective ignores one important aspect: holding cash is a viable alternative for small amounts of money but becomes a logistical issue and involves increasing costs of safekeeping as the amounts become larger. For example, holding 10m or 1bn euros as 'cash on hand' would require running banking-like operations.

7. The challenge for some investors has become how to keep cash that they are not willing to invest for the longer term without being exposed to credit risk they are not willing to accept? Some investors that used bank deposits have been increasingly concerned about the credit risk[4] (often in conjunction with decreasing deposit rates) while other investors have traditionally preferred government securities. The shift in investors' behaviour (moving from other financial products such as bank deposits to government securities as well as shifting from medium to longer term investments into shorter maturities because of low interest levels) means they are now facing a situation in which they have to accept negative interest rates for some of their investments in 'safe harbour' assets.

8. Economically, the negative interest rates mean that investors in effect pay a fee to a custodian for safekeeping of their money. Compared to the costs for physically holding cash this can be the cheaper alternative.

Presentation of interest revenue and expense under IFRSs

The notion of interest revenue

9. IFRSs include requirements for interest revenue in IAS 18 *Revenue* and IAS 39 Financial Instruments: Recognition and Measurement[5].

10. The scope[6] of IAS 18 includes interest revenue. IAS 18 describes interest revenue as follows:[7]

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[4] The deposits of large commercial investors are typically not covered by government deposit guarantee schemes (because of their size and/or type of depositor).
[5] IFRS 9 *Financial Instruments* incorporates those requirements by reference (see IFRS 9.5.2.1 and 5.3.1).

> The use by others of entity assets gives rise to revenue in the form of:
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> (a) interest—charges for the use of cash or cash equivalents or amounts due to the entity; […]

11. IAS 18 defines revenue as [emphasis added]: [8]

> *Revenue* is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

12. It is clear from the description of interest revenue in IAS 18 that it cannot be 'negative' in terms of an outflow of economic benefits.[9] It follows that interest *revenue* cannot arise from an asset that has a negative effective interest rate because that means there is an outflow of economic benefits arising from the use by others of the entity's asset.

13. The effective interest method in IAS 39 does not override the characterisation of amounts as revenue in IAS 18. The effective interest method in IAS 39 deals simultaneously with the measurement of an asset or liability at amortised cost as well as *allocating* the resulting interest income or expense.[10] IAS 18.30(a) refers to the effective interest method in IAS 39 for determining the amount *recognised*[11]—but that amount still has to be revenue as explicitly stated in that paragraph (and because that is the only type of item that IAS 18 addresses and thus refers to).

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[6] See IAS 18.1(c).
[7] See IAS 18.5(a).
[8] See IAS 18.7.
[9] Revenue can only be reduced by discounts or rebates (see IAS 18.10) but not be negative as a whole for a transaction. Also, when uncertainty about collectibility arises after an amount was recognised as revenue that does not result in a reversal of the previously recognised revenue but instead an expense (see IAS 18.34).
[10] See IAS 39.9 (definition of the "effective interest method").
[11] When applying the effective interest method, 'recognition' relates to both timing of the recognition and the measurement (those two aspects are inextricably linked in an effective yield concept).

Can positive and negative amounts arising from the effective interest method be aggregated and presented as a single line item?

14. The next question is whether amounts that arise from applying the effective interest method that cannot be characterised as revenue under IAS 18 can be aggregated with interest revenue and presented within the same line item in the statement of comprehensive income.

15. IAS 1 includes requirements for offsetting income and expenses. Those prohibit offsetting of income and expenses unless it is required or permitted by an IFRS[12] and explicitly mention revenue[13]. Hence, in the staff's view negative amounts arising on some assets when applying the effective interest method must not be offset against interest revenue arising on other assets.

16. The fact that the definition of the effective interest method refers to allocating interest income or interest expense does not mean that IAS 39 allows offsetting those different types of amounts.[14] Instead it reflects that the definition deals with the amortised cost measurement of both assets and liabilities.

17. Similarly, the fact that IFRS 7 requires disclosure of whether net gains or losses include interest income[15] does not constitute a permission or requirement for offsetting negative amounts against interest revenue.[16] Instead, that requirement reflects that entities may present interest (or dividend) income on items measured at fair value through profit or loss separately from the net gains or losses arising on those instruments.[17] *If* an entity decides to present interest income separately, the offsetting requirements of IAS 1 apply to that interest income. Conversely, if an entity decides not to present interest income

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[12] See IAS 1.32.
[13] See IAS 1.34.
[14] This was the background of an annual improvement in May 2008 that corrected the implementation guidance on IFRS 7 *Financial Instruments: Disclosures*. Paragraph IG13 had incorrectly stated that interest income and interest expense were a component of the "finance costs" that IAS 1 required to be presented separately in the income statement. This was corrected on the basis that the statement was inconsistent with the offsetting requirements of IAS 1.32 that preclude offsetting of income and expenses except when required or permitted by an IFRS.
[15] See IFRS 7.B5(e).
[16] Otherwise the annual improvement in May 2008 (see footnote 14) would not have been necessary.
[17] See IFRS 7.BC34.

separately then the notion of interest income is not applicable (and the offsetting requirements apply to the net gain or loss as a whole).

18. In any case, in the staff's view this requirement:

    (a) is only intended to give clarity about the accounting policy an entity has adopted; and

    (b) only addresses the issue of whether interest is treated as separate item but not whether interest income and expense are offset—in particular it does not address whether interest income on one asset can be offset against an expense arising on a different item.

19. Therefore, this requirement cannot be construed to permit offsetting interest income on some assets against an expense arising on other items thereby overriding the general offsetting requirements in IAS 1. For financial instruments classified as other than fair value through profit or loss, interest revenue must be recognised anyway in accordance with IAS 18 and the effective interest method so that the general offsetting requirements in IAS 1 apply.

The notion of interest expense

20. The requirements of IAS 18 only apply to revenue. IFRSs do not have an equivalent standard for interest expense that is as specific. However:

    (a) the general offsetting requirements of IAS 1 apply equally to interest expense;[18]

    (b) the effective interest method applies equally to interest expense;[19] that has in practice also resulted in using the illustrative examples that accompany IAS 18 for determining what types of costs or fees paid by the borrower are included in applying the effective interest method (for liabilities);

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[18] See IAS 1.32–33.
[19] See IAS 39.9.

(c) the structure of the disclosure requirements in IFRS 7 treats interest income and interest expense equally.[20]

21. Therefore, despite the absence of an equivalent to IAS 18 for interest expense the staff consider that the above analysis regarding interest revenue also applies to interest expense.

Conclusion

22. The analysis of the IFRS requirements regarding the presentation of interest revenue and expense demonstrates that interest resulting from a negative interest rate on a financial asset must *not* be presented as a negative part of interest revenue (ie a reduction). Doing so would be:

(a) inconsistent with the notion of interest revenue under IFRSs; and

(b) violate the offsetting requirements for revenue and expenses.

23. This applies accordingly to interest resulting from a negative interest rate on a financial liability, which must not be presented as a negative part of interest expense (ie a reduction).

24. In the staff's view presenting 'negative' interest would also not faithfully represent the economic phenomenon— that investors in effect pay a fee to a custodian for safekeeping of their money.

What is the appropriate presentation of 'interest' arising from negative interest rates?

25. If interest arising from negative interest rates on assets and liabilities is not presented as negative interest revenue or interest expense that raises the question of how it should be presented in the statement of comprehensive income.

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[20] See IFRS 7.20.

Does the definition of the effective interest method imply an answer?

26. As mentioned before[21], the definition of the effective interest method refers to the allocation of both interest income and expense. This appears to imply that any amortisation amount included in profit or loss that results from applying the effective interest method should be presented as either interest revenue or interest expense.

27. However, that would mean presenting for negative interest scenarios 'interest expense' arising from financial assets and 'interest revenue' arising from liabilities. This would result in an obvious mischaracterisation of the amount in the statement of comprehensive income:

    (a) As mentioned before[22], the notion of interest revenue under IFRSs relates to charges for the *use by others of entity assets*, namely for the use of cash or cash equivalents or amounts *due to* the entity. Hence, even though it is a gross inflow of economic benefits, the interest that the borrower receives on its financial *liability* in case of a negative interest rate does *not* meet the definition of interest revenue.

    (b) Similarly, even though it is a gross outflow of economic benefits, the interest that the holder pays on its financial *asset* in case of a negative interest rate is *not* interest expense. The same consistency considerations mentioned before apply.[23] In addition, if interest in this situation was presented as interest expense, it would become a component of '*finance costs*' that are required to be presented as a separate line item in the statement of comprehensive income.[24] A further consequence of characterising such amounts as 'interest expense' would be that the amounts paid by the holder on its financial

[21] See paragraph 13.
[22] See paragraph 10.
[23] See paragraphs 20–21.
[24] See IFRS 7.IG13. In addition, that paragraph refers to including amounts associated with non-financial *liabilities* (thereby implying the amounts included related to charges that arise on liabilities—not assets).

asset would meet the definition of borrowing costs in IAS 23 *Borrowing Costs*.[25] Depending on the judgement used in determining capitalisation rates[26] this might result in an entity capitalising those amounts as part of the cost of a qualifying asset.

28. Hence, the definition of the effective interest method cannot be construed to require that the amounts resulting from a negative interest rate on a financial asset are presented as 'interest expense' instead of some other type of expense (or for a financial liability as 'interest revenue' instead of some other type of income). Given that the economic phenomenon of a negative interest rate is rare, it is plausible to assume that when it developed IAS 39 the IASB did not envisage that the effective interest method would be applied in such a situation. The basis for conclusions of IAS 39 does not mention this situation.

What are the alternatives for presentation in the statement of comprehensive income?

29. The mischaracterisation that would result from presenting 'interest expense' arising from financial assets and 'interest revenue' arising from liabilities can also be illustrated with a simple (deliberately extreme) example: an entity has interest bearing assets with a positive yield and keeps shorter term highly liquid financial assets with a negative yield as an alternative to cash. The entity is entirely funded with equity. Assume that the amounts recognised in profit or loss for the assets with the positive yield is CU+10 and for the assets with the negative yield CU-10.

30. If the amount recognised in profit or loss for the assets with the negative yield was presented as 'interest expense' the entity would show in its statement of comprehensive income:

    (a) Interest revenue of CU10;

    (b) Interest expense of CU10; and

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[25] See IAS 23.6(a), which explicitly refers to "interest expense calculated using the effective interest method as described in IAS 39".

[26] See IAS 23.11 and 14.

(c) Profit or loss of CU0.

31. Given that the entity is entirely funded by equity (and also does not have an interest margin business) this presentation would not be a faithful representation of its financial performance.

32. Alternatively, if the amount recognised in profit or loss for the assets with the negative yield was presented as 'negative interest revenue' (a view already dismissed earlier in this paper[27]—only presented for comparison) the entity would show in its statement of comprehensive income:

(a) Interest revenue of CU0; and

(b) Profit or loss of CU0.

33. This presentation would not be a faithful representation of the entity's financial performance given that it earned interest revenue and incurred expenses on keeping its liquid funds in assets with a negative yield.

34. The staff consider that the following presentation in the statement of comprehensive income would faithfully represent the financial performance of the entity and be consistent with the economic phenomenon of a negative yield:

(a) Interest revenue of CU10;

(b) Other financial expenses of CU10; and

(c) Profit or loss of CU0.

35. IFRSs do not prescribe a particular line item description for the expense of CU10. However, IAS 1 envisages that additional line items might have to be presented but leaves the particular labelling open. The descriptions have to be selected so that they are useful in explaining the elements of financial performance.[28] Some considerations in this respect are:

[27] See paragraph 22.
[28] See IAS 1.85–86.

(a) Other labels than "Other financial expenses" could be chosen. In this extreme example, given there are no other items, the description in the statement of comprehensive income could be more specific (eg "Financial expense on keeping liquid short-term assets"). For entities that have many other transactions and similar financial expense items the amount would be included in another line item such as "Other financial expense" (depending on how it fits into the entity's circumstances).

(b) The line item in which the amount is included should *not* roll up into the mandatory line item for finance costs (because the expense arises in conjunction with an *asset*[29]).

(c) The concept of materiality applies also to presentation and aggregation.[30]

Conclusion

36. The staff consider that a faithful representation of an entity's financial performance requires the following presentation in the statement of comprehensive income:

(a) amounts resulting from a negative interest rate on a financial *asset* are presented as an expense other than 'interest expense'[31] (and in a line item that does *not* roll up into the mandatory line item for finance costs).

(b) amounts resulting from a negative interest rate on a financial *liability* are presented as income other than 'interest revenue'[32].

37. The staff consider that this presentation is consistent with:

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[29] See paragraph 27(b).
[30] See IAS 1.29–30 and 86; IAS 8.8.
[31] Regarding further considerations for the particular line item see paragraph 35.
[32] Regarding further considerations for the particular line item see paragraph 35.

(a) the economic phenomenon of a negative yield; and

(b) existing IFRS requirements.

Staff recommendation

38. In the staff's view the appropriate presentation in the statement of comprehensive income for income and expenses arising on financial instruments with a negative interest rate can be derived from existing IFRSs without need for further guidance. Consequently, the staff do not think that any changes to or formal interpretation of IFRSs are needed. Hence, the staff consider that the Committee's agenda criteria[33] are not met and recommend that the Committee should not take this issue onto its agenda.

39. However, the staff want to ask the Committee whether it thinks that it should take action to avoid divergence in practice developing. If the Committee wants to take action, the staff consider that including in the Update the conclusion of the analysis in this paper together with references to the relevant IFRSs would be the most efficient approach.

Questions for the Committee
1. Does the Committee agree with the staff's analysis of the presentation in the statement of comprehensive income for income and expenses arising on financial instruments with a negative interest rate? 2. Does the Committee agree with the draft tentative agenda decision? 3. Does the Committee want to take any other action (ie other than publishing a tentative agenda decision?

[33] The agenda criteria are set out in Appendix B for reference.

Appendix A—Proposed wording for tentative agenda decision

A1 The staff propose the following wording for the tentative agenda decision:

Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income

The Committee discussed the ramifications of the economic phenomenon of negative interest rates for the presentation of income and expenses in the statement of comprehensive income.

The Committee noted that IAS 18 *Revenue* and IAS 1 *Presentation of Financial Statements* include guidance on what is interest revenue and whether income and expenses can be offset. The Committee considered that interest resulting from a negative interest rate on a financial asset must not be presented as a 'negative' part of interest revenue (ie a reduction) because doing so would be:

(a) inconsistent with the notion of interest revenue under IFRSs; and

(b) violate the offsetting requirements for revenue and expenses.

This applies accordingly to interest resulting from a negative interest rate on a financial liability, which must not be presented as a negative part of interest expense (ie a reduction).

The Committee considered that the following presentation in the statement of comprehensive income would be appropriate:

(a) presenting amounts resulting from a negative interest rate on a financial asset as an expense other than 'interest expense' (and in a line item that does not roll up into the mandatory line item for finance costs).

(b) presenting amounts resulting from a negative interest rate on a financial liability as income other than 'interest revenue'.

In the Committee's view this presentation is consistent with:

(a) the economic phenomenon of a negative yield; and

(b) existing IFRS requirements.

The Committee considered that in the light of its analysis of the existing IFRS requirements an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.

Appendix B—Agenda criteria

(a) *The issue is widespread and has practical relevance.*

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Not applicable. We are not aware of different reporting methods.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*