

STAFF PAPER

January 2013

IFRS Interpretations Committee Meeting

Project	IAS 39 <i>Financial Instruments: Recognition and Measurement</i>		
Paper topic	Negative interest rates: implication for presentation in the statement of comprehensive income		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. 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*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

Introduction

1. In September 2012, the IFRS Interpretations 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 Interpretations Committee considered the situation where, against the backdrop 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), being the overall effective interest rate, has turned negative.
2. The Interpretations Committee noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue* because it reflects a gross outflow, instead of a gross inflow, of economic benefits. The Interpretations Committee also noted that this amount is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. The Interpretations Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, the

entity is required to present additional information about such an amount if that is relevant to an understanding of the entity's financial performance or to an understanding of this item.

3. The Interpretations Committee considered that in the light of the existing IFRS requirements an interpretation was not necessary and tentatively decided not to add the issue to its agenda

Comment letter summary

4. The comment period for the tentative agenda decision ended on 26 November 2012 and four responses¹ were received. One² of them agreed with the Interpretations Committee's decision not to add this item to its agenda for the reasons provided in the tentative agenda decision.
5. Another respondent³ agreed with the tentative decision but does not believe the agenda decision should take such an absolute position. Instead, the respondent recommends that the agenda decision retain its analysis of the requirements of IAS 1 (on the requirement to present additional information relevant to an understanding of an entity's financial performance) and allow entities to apply judgement in determining the appropriate presentation in profit or loss.
6. Another respondent⁴ agreed with the tentative decision not to add this to the agenda but did not agree with the analysis or reasons provided. This respondent was concerned about having to present the cash flows arising from the contractual interest rate separate from those arising from any premium or discount if the effect of the sum of both components may lead to a negative yield.

¹ Accounting Standards Committee of Germany, KPMG IFRG Limited, Deloitte Touche Tohmatsu Limited, Canadian Accounting Standards Board

² Canadian Accounting Standards Board

³ Deloitte Touche Tohmatsu Limited

⁴ Accounting Standards Committee of Germany

7. The remaining respondent⁵ expressed concerns about unintended consequences on other active projects such as IFRS 9 and recommends that the Interpretations Committee refrain from finalising the tentative agenda decision. The issues raised by this respondent included the following:
- (a) The issue under consideration does not represent a formal agenda request, but rather a potential issue identified by the staff; and
 - (b) The interaction of this tentative agenda decision with the amortised cost criteria in IFRS 9 and the proposed impairment approach being developed.

Analysis of issues raised

Issue does not represent a formal agenda request

8. As mentioned in Agenda Paper 14 that was discussed at the September 2012 meeting, although a formal agenda request has not yet been received, the staff have received several informal requests for guidance on how such amounts should be presented. The staff believe that clarification should be provided as informal outreach indicated that divergence may have already started developing as some are of the opinion that accounting for positive yields should automatically be applied to negative yields while others exclude such amounts from interest revenue.

Drafting suggestions

9. As mentioned in paragraph 5 above, one respondent⁶ do not believe that the absolute position taken (i.e., that these amounts are neither interest income nor interest expense) is appropriate as it assumes that the negative yield results from the issuer charging a custodian fee for safeguarding the holder's money. In the respondents view this may not be the case in every scenario as there might be other circumstances leading to a negative yield. The respondent therefore

⁵ KPMG IFRG Limited

⁶ Deloitte Touche Tohmatsu Limited

recommends that the agenda decision should retain its analysis of the requirements of IAS 1 (on the requirement to present additional information relevant to an understanding of an entity's financial performance) but rather observe that, in the absence of any definitive guidance on the presentation of negative interest, judgement should be applied in determining the appropriate classification within profit or loss

10. The staff note, that as discussed in paragraph 8 above, several informal enquiries have been received recently and that there appears to be divergence in how entities are presenting such amounts currently. Further, the staff believe that irrespective of the reason for the negative return, the effect is that there is a negative return on an asset which does not represent revenue and that a negative return on an asset also does not represent an interest expense. In the light of this and the general requirement in IAS 1 to present income and expense on a gross basis, the staff believe that clarification is needed that these amounts should not be aggregated with interest revenue or interest expense and are therefore not recommending any changes to the wording of the tentative agenda decision as published.
11. Another respondent⁷ was concerned about having to present the cash flows arising from a low contractual interest rate separate from those arising from any premium or discount if the effect of the sum of both components may lead to a negative yield.
12. The effective interest rate on a financial instrument is determined by discounting all contractual cash flows on the instrument to its fair value and thus comprises both the coupon and any premium or discount. The staff note that the issue addressed by the Interpretations Committee only deals with situations where the overall effective interest rate is negative and propose to reiterate this by clarifying the first paragraph of the proposed wording for the final agenda decision as set out in Appendix A.

⁷ Accounting Standards Committee of Germany

Interaction with the amortised cost criteria in IFRS 9 and the proposed impairment approach being developed

13. One respondent⁸ noted that in accordance with IFRS 9, a financial asset can only be measured at amortised cost if the contractual cash flows on the asset give rise to payments that are solely payments of principal and interest on the principal amount outstanding⁹. The respondent further noted that in the context of IFRS 9 interest represents compensation for time value of money and credit risk only. The respondent is of the opinion that if the tentative agenda decision concludes that the economic return on a financial asset with a negative yield represents neither interest revenue nor interest expense, it may not be possible to conclude that the contractual cash flows are solely payments of principal and interest (SPPI). This respondent is concerned that such financial assets will therefore not be eligible for measurement other than at fair value through profit or loss.
14. The staff note that the issue addressed by the Interpretations Committee related only to the appropriate *presentation* of a negative yield on a financial asset. The primary question raised was whether a negative return can be properly presented as revenue and, if the answer to that question is no, whether a negative return on a financial asset can instead be presented as interest expense. The draft agenda decision only addresses these questions, it does not further analyse the nature of those payments, so should not affect the financial instruments that can be considered to have payments that are SPPI. That is a separate issue subject to consideration in the Board's active project on the classification and measurement of financial instruments.
15. The respondent was also concerned about the implications for the tentative impairment model being developed by the IASB, where in accordance with the tentative decisions to date, it is proposed that an entity would be able to use as a discount rate, any rate between a risk-free rate and the financial asset's original

⁸ KPMG IFRG Limited

⁹ In accordance with the recently issued ED *Classification and Measurement: Limited Amendments to IFRS 9*, the contractual cash flow characteristics also apply to the fair value through other comprehensive income measurement category.

EIR. The respondent is of the view that for assets with a negative yield, the negative yield would be the closest proxy to a risk-free rate and questions the appropriateness of measuring impairment using a negative discount rate. In the staff's view the determination of the risk-free rate is an economic question. The tentative agenda decision does not change the way in which a risk-free rate is determined. The proposal to allow the risk-free rate to be used as the discount rate will in any event be included in the Board's forthcoming exposure draft on the expected loss impairment model.

Staff recommendation

16. The staff recommend confirming the tentative agenda decision that the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification.

Question to the Interpretations Committee

Question for the Interpretations Committee
Does the Interpretations Committee agree with the proposed rejection wording in Appendix A?

Appendix A—Proposed wording for final agenda decision

- A1. The staff propose the following wording for the final agenda decision. New text is underlined and deleted text is struck through.

IAS 39 *Financial Instruments: Recognition and Measurement* Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income

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

The Interpretations Committee noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue* because it reflects a gross outflow, instead of a gross inflow, of economic benefits. The Interpretations Committee also noted that this amount is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. The Interpretations Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, the entity is required to present additional information about such an amount if that is relevant to an understanding of the entity's financial performance or to an understanding of this item.

The Interpretations Committee considered that in the light of the existing IFRS requirements an interpretation was not necessary and consequently ~~{decided}~~ not to add the issue to its agenda.

Mr Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London
United Kingdom
EC4M 6XH

Email: ifric@ifrs.org

28 November 2012

Dear Mr Upton,

Tentative agenda decision: IAS 39 Financial Instruments: Recognition and Measurement – Income and expenses arising on financial instruments with a negative yield – presentation in the statement of comprehensive income

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretation Committee's publication in the September 2012 *IFRIC Update* of the tentative decision not to take onto the IFRIC's agenda a request for interpretation of the appropriate presentation in the statement of comprehensive income of interest resulting from a negative effective interest rate on a financial asset.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda but do not believe that the absolute position taken (i.e., that these amounts are neither interest income nor interest expense) is appropriate as it assumes that the negative yield results from the issuer charging a custodian fee for safeguarding the holder's money. This may not be the case in every scenario as there might be other circumstances leading to a negative yield.

This question could only be fully resolved following a project to consider thoroughly what is, and is not, included in the effective interest rate calculation in the variety of circumstances that might result in a negative yield on a financial asset. We do not believe that such a project should be undertaken as negative yields on financial assets are unlikely to form a significant part of entities' financial performance.

As a result, we believe that the agenda decision should retain its analysis of the requirements of IAS 1 (on the requirement to present additional information relevant to an understanding of an entity's financial performance) and observe that, in the absence of any definitive guidance on the presentation of negative interest, judgement should be applied in determining the appropriate classification within profit or loss.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0)20 7007 0884.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'V. Poole', written in a cursive style.

Veronica Poole
Global IFRS Leader
Technical

November xx, 2012

(via email to ifric@ifrs.org)

IFRS Interpretations Committee
30 Cannon Street, 1st Floor
London EC4M 6XH
United Kingdom

Dear Sirs:

IAS 39 Financial Instruments: Recognition and Measurement—Income and expenses arising on financial instruments with a negative yield —presentation in the statement of comprehensive income

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the IFRS Interpretations Committee's tentative agenda decision on accounting for investments with a negative yield.

The views expressed in this letter take into account comments from individual members of the AcSB staff but do not necessarily represent a common view of the AcSB or its staff. Views of the AcSB are developed only through due process.

We agree with the Committee's decision not to add this item to its agenda for the reasons provided in the tentative agenda decision.

If you require further information, please contact me at +1 416 204-3276 (email peter.martin@cica.ca) or Kate Ward, Principal, Accounting Standards at +1 416 204-3437 (email kate.ward@cica.ca).

Regards,



Peter Martin, CPA, CA
Director, Accounting Standards



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Wayne Upton
Chairman of the
IFRS Interpretations Committee
30 Cannon Street
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Berlin, 23 November 2012

United Kingdom

Dear Wayne,

IAS 39 – Income and expenses arising on financial instruments with a negative yield – presentation in the statement of comprehensive income

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the IFRSIC's tentative agenda decision, published in the September 2012 *IFRIC Update*, not to add the issue to its agenda.

We disagree with the IFRSIC's tentative agenda decision for the following reasons:

- The interest yield of a financial asset can contain several components, some of which can be negative;
- interest cash flows with a negative yield component or even a total negative yield are, intuitively and economically, still considered part of (net) interest income;
- interest cash flows from a financial asset can be negative as a temporary and exceptional phenomenon – but are still interest revenue;
- adding positive with negative yield components of the same origin (same instrument) is not a matter of offsetting but of aggregation;
- the definition of revenue is interpreted too narrow in the context of IAS 18 but not as a financial instrument's issue.

Our rationale for the above is as follows: Firstly, we agree that interest cash flows of an asset resulting in a negative yield cannot be considered interest expenses, thus, we agree with the argument that interest expenses can arise on liabilities only. Secondly, we also agree that interest revenue and interest expenses must not be offset. However, we consider both positive and negative interest cash flows from a financial



asset being revenue, hence, adding (temporarily) negative interest cash flows (i.e. negative yield) with positive interest cash flows does not violate offsetting constraints.

Let us consider two examples:

- A financial asset with a low coupon issued with a high premium would lead to recognising the interest rate coupon as a positive yield component and the amortisation of the premium as a negative yield component, with the effect that the sum of both components may lead to a (total) negative yield.
- A high quality government bond issued with a coupon that resets at, for instance, three months LIBOR minus credit spread, where the discount from LIBOR for the credit risk of the bond is higher than the prevailing LIBOR rate may lead to a negative yield for certain periods.

In the first example, the negative (amortisation) yield component would be presented as part of interest revenue, probably not even separate from the positive (coupon) yield component. In the second case, during "positive" periods the yield would obviously be presented as interest revenue. In both cases, it would be counter-intuitive, even impracticable, to present cash flows of the same nature and origin as interest revenue during one period (e.g. first quarter of a year), but as any other (non-interest) expense during the next period (e.g. second quarter of the same year).

Finally, considering a negative yield as "fee for custody" seems inappropriate to us since it is neither implicitly/explicitly agreed upon nor is it empirically approved; it is merely an assertion. If presuming so, any yield of any financial asset/liability would implicitly be split into a "pure interest" component and a "custody fee" component – e.g. deposits, current accounts (usually having a low interest rate) – with both being presented separately. For obvious reasons, we would deny this assertion.

Therefore, we suggest that the IFRSIC reconsider and change its tentative decision such that interest cash flows can exceptionally and temporarily be negative with the nature of interest revenue still being preserved. As argued above, negative interest yield from a financial asset should be presented as part of interest revenue, thus, being part of interest (net) income.

If you would like further clarification of the issues set out in this letter, please do not hesitate to contact me.

With best regards,

Liesel Knorr

President



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Mr Wayne Upton
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Our ref MV/288

Contact Mark Vaessen

28 November 2012

Dear Mr Upton

Tentative agenda decision: IAS 39 Financial Instruments: Recognition and Measurement – Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income

We are writing to express our concerns about the tentative agenda decision, *IAS 39 Financial Instruments: Recognition and Measurement – Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income*.

We believe that there are more important accounting issues around negative yields than the question of presentation of income or expense. Accordingly, we do not believe that it is appropriate to form a conclusion with respect to presentation until those wider issues have been considered as part of the IASB's deliberations on classification and measurement and impairment of financial instruments.

Under IFRS 9 *Financial Instruments*, a financial asset can only qualify for amortised cost measurement if 'the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding'. For the purpose of making that assessment, interest is 'consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.' If the Interpretations Committee concludes in its agenda decision that the economic return on a financial asset with a negative yield represents neither interest income nor interest expense, then it might be argued to be inconsistent to simultaneously take the view that that the cash flows of that same financial assets represent 'solely payments of principal and interest.'

In addition, in paragraph 7 of agenda paper 5A of the February 2012 IASB meeting, the IFRS Foundation Staff state:

Principal is not defined in IFRS 9; however, BC4.23 states that ‘cash flows that are interest always have a close relation to the amount advanced to the debtor (the ‘funded’ amount)’. That is, principal is understood as economic principal.

A financial asset with a negative yield by definition has an initial cost that exceeds the total cash flows to be received over time. If the initial cost (or funded amount) is considered to be the ‘principal’ of the instrument and the overall return or potential “interest” in IFRS 9 terms is negative, it may be difficult to conclude that the cash flows provide consideration for the credit risk associated with the principal amount outstanding.

However, it would be difficult to understand the conceptual basis for high quality financial assets failing to qualify for amortised cost accounting simply because they are of such high quality that they have a negative yield in a time of financial strain or in a deflationary environment. Furthermore, if such assets were considered to meet the “solely payments of principal and interest” criterion in IFRS 9, it would then appear to be difficult to preclude the return on those assets, or some component thereof, from being presented as interest revenue.

More generally, the agenda paper submitted by the Staff to the Committee in September stated that the phenomenon of negative interest is “that investors in effect pay a fee to a custodian for safekeeping of their money.” If so, such a fee for safekeeping might be considered to be present in many other deposit or investment arrangements – it is just that in most cases the amount of the fee does not make the overall return negative. This analysis raises additional complications that do not appear to have been considered by the Committee:

- how the notion of a safekeeping fee is consistent with concept of principal and interest in IFRS 9; and
- whether the overall return could be bifurcated into a safekeeping fee and other components.

The phenomenon of negative yields also has implications for the model the IASB is developing for the impairment of financial assets under IFRS 9. In accordance with the IASB’s tentative decisions to date, an entity would be able to measure impairment on any financial asset within the scope of the impairment project using a discount rate between the risk free rate (that should be a benchmark interest rate) and the financial asset’s effective interest rate. If there are high-quality financial assets with a negative yield, then the negative yield on those assets would presumably be the closest proxy for the risk-free rate. However, the IASB has not stated whether the risk-free rate used for measuring impairment may be a negative interest rate and, if so, what the measure would conceptually represent.



KPMG IFRG Limited
Tentative agenda decision: IAS 39 Financial Instruments: Recognition and Measurement – Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income
28 November 2012

In conclusion, we ask that the Interpretations Committee reconsider its tentative agenda decision on the presentation of negative interest rates. Since we understand that this issue does not represent a formal agenda request to the Interpretations Committee, but rather a potential issue identified by the IFRS Foundation Staff, we do not see a need for the Interpretations Committee to publish a final agenda decision and believe that it should not do so unless and until the broader issues mentioned above have been discussed.

We would also ask the IFRS Foundation Staff and the IASB to consider the implications of negative yields as part of the IASB's deliberations on classification and measurement and impairment of financial instruments. We believe that refraining from issuing the tentative agenda decision as drafted would provide the IASB with greater freedom to consider fully the accounting implications of negative yields.

Please contact Mark Vaessen on +44 (0) 20 7694 8589 or Chris Spall on +44 (0) 20 7694 8445 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited