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STAFF PAPER

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Project	Primary Financial Statements
Paper topic	Classification of income and expenses in the financing category of the statement of profit or loss

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Objective

1. In May 2021, the Board agreed to explore the approach set out in Agenda Paper 21A of that meeting for classifying items of income and expenses in the financing category of the statement of profit or loss.

2. The approach relates to income and expenses arising from liabilities only. In May 2021, the Board decided to classify income and expenses arising from cash and cash equivalents in the investing category, resulting in the financing category including only income and expenses arising from liabilities.[1]

3. The approach also applies only to entities other than those with specific main business activities, such as investing and the provision of financing to customers. The classification of items of income and expenses in the financing category for entities with specific main business activities will be discussed at a future meeting.

4. The approach set out in Agenda Paper 21A of the May 2021 Board meeting is that:

[1] There are two exceptions when amounts related to assets are classified in the financing category—net interest on assets for defined benefit pension plans and the unwinding of the discount in the present value of the costs to sell of a non-current asset held for sale (see row on IFRS 5 in table 1 in Appendix A).

(a) the Board require the following income and expenses to be classified in the financing category of profit or loss:

(i) all income and expenses from liabilities that arise from transactions that involve only the raising of finance; and

(ii) interest income and expenses from other liabilities; and

(b) the Board describe transactions that involve only the raising of finance as transactions that involve:

(i) the receipt by the entity of cash, a reduction in a financial liability or an entity's own equity;[2]; and

(ii) the return by the entity of cash or an entity's own equity.

5. This paper sets out further staff analysis of that approach. It should be read in conjunction with Agenda Paper 21B *Classification of gains and losses on derivatives and hedging instruments* and Agenda Paper 21C *Classification of foreign exchange differences* of this meeting.

6. Future papers will discuss:

(a) the proposals for income and expenses to be classified in the financing category in the statement of profit or loss for entities with specified main business activities;

(b) minimum line items related to income and expenses classified in the financing category;

(c) whether incremental expenses related to financing activities should be classified in the financing category;

(d) the classification of income and expenses arising under IAS 29 *Financial Reporting in Hyperinflationary Economies*; and

(e) interest and penalties on uncertain tax positions.

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[2] Agenda paper 21A of the May 2021 Board meeting did not include an entity's own equity in this criterion. But the staff explained at that Board meeting that it was necessary to include it in order to capture liabilities such as a liability to purchase own shares.

Summary of staff recommendations

7. The staff recommend the Board confirm the approach discussed in the May 2021 meeting, that is:
   (a) to require the following income and expenses to be classified in the financing category of profit or loss:
      (i) for liabilities that arise from transactions that involve only the raising of finance—all income and expenses; and
      (ii) from other liabilities—interest expense and the effect of changes in interest rates, when such amounts are identified applying the requirements of IFRS Standards;
   (b) to describe transactions that involve only the raising of finance as transactions that involve:
      (i) the receipt by the entity of cash, a reduction in a financial liability or an entity’s own equity; and
      (ii) the return by the entity of cash or an entity's own equity.
8. The staff also recommend, in relation to hybrid contracts with embedded derivatives, the Board require:
   (a) income and expenses relating to separated host liabilities to be classified in the same way as income and expenses on other liabilities;
   (b) income and expenses relating to separated embedded derivatives to be classified in the same way as income and expenses on stand-alone derivatives;
   (c) income and expenses related to contracts that are not separated to be classified in the same way as income and expenses on other liabilities.

Structure of the paper

9. This paper is structured as follows:
   (a) proposals in the Exposure Draft and feedback from the May 2021 Board meeting (paragraphs 10–17);

(b) staff analysis (paragraphs 18–60);

(i) the objective of classifying of items of income and expenses in the financing category (paragraphs 19–20);

(ii) an analysis of income and expenses arising from the requirements of IFRS Standards (paragraphs 21–52); and

1. the effect of embedded derivatives on the classification of income and expenses in the financing category (paragraphs 29–43);

2. the effect of fair value options in IFRS 9 on the classification of income and expenses in the financing category (paragraphs 44–49);

3. summary of conclusions from analysis of income and expenses from IFRS Standards (paragraphs 50–52); and

(iii) what items of income and expenses should be classified in the financing category for liabilities that combine financing and another activity (paragraphs 53–60).

(c) Appendix A—analysis of types of income and expenses arising from IFRS Standards on liabilities.

(d) Appendix B—analysis of the classification of income and expenses arising from hybrid contracts for which the embedded derivative is not separated.

The proposals in the Exposure Draft and feedback from May 2021 Board meeting

Proposals in the Exposure Draft

10. Paragraph 49 of the Exposure Draft proposed the financing category would include:[3]

[3] Also see paragraphs B34–B37 and BC33–BC47 of the Exposure Draft.

(a) income and expenses from cash and cash equivalents (discussed in May 2021 Agenda Paper 21B *Subtotals and categories—profit before financing and income tax*);

(b) income and expenses on liabilities arising from financing activities; and

(c) interest income and expenses on other liabilities, for example, the unwinding of discounts on pension liabilities and provisions.

11. Paragraph 50 of the Exposure Draft proposed to define liabilities arising from financing activities as those involving the receipt or use of a resource from a provider of finance with the expectation that:

(a) the resource will be returned to the provider of finance; and

(b) the provider of finance will be compensated through the payment of a finance charge that is dependent on both the amount of the credit and its duration.

12. Paragraph B35 of the Exposure Draft gave as examples of liabilities arising from financing activities:

(a) debentures, loans, notes, bonds and mortgages;

(b) lease liabilities; and

(c) trade payables (for example those negotiated on extended credit terms).

13. Paragraph B37 of the Exposure Draft gives the following examples of interest income and expenses on liabilities not arising from financing activities in the financing category:

(a) net interest expense (income) on a net defined benefit liability (asset) applying IAS 19 *Employee Benefits*;

(b) unwinding of the discount on a decommissioning, restoration or similar liability;

(c) unwinding of the discount on other long-term provisions, for example warranty provisions and deferred consideration for a business combination; and

(d) increases in the present value of the costs to sell a non-current asset (or disposal group) held for sale that arise from the passage of time as discussed in paragraph 17 of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Feedback from the May 2021 Board meeting

14. Agenda Paper 21A of the May 2021 Board meeting explained that the proposals in the Exposure Draft raised questions about the classification of liabilities arising from financing activities that were difficult to resolve, for example who is a provider of finance, must the resource that is returned be the same as the resource received and what is a finance charge. Accordingly, the staff proposed an alternative approach which is not to focus on *liabilities* arising from financing activities but instead to focus on how best to identify *income and expenses* to be classified in the financing category.

15. Specifically, the approach involves distinguishing between liabilities that:

   (a) **arise from transactions that involve only financing activities**, for example corporate bonds, bank loans and mortgages. The outcome of such transactions is solely the raising of finance for the entity's operating or investing activities. The transactions do not themselves involve any operating or investing activities. Hence, all resulting income and expenses should be categorised as financing.

   (b) **arise from transactions that combine financing with another activity**, for example payables to suppliers with extended credit terms, lease liabilities and pension liabilities. The outcome of such transactions is both an operating (or investing) activity and a financing component. Hence, it is necessary to identify which items of income and expenses should be classified as financing.

16. Agenda Paper 21A of the May 2021 Board meeting also suggested that transactions that involve only the raising of finance should be described as transactions that involve:

(a) the receipt by the entity of cash, a reduction in a financial liability or an entity's own equity;[4] and

(b) the return by the entity of cash or an entity's own equity.

17. The Board agreed to explore the approach set out in Agenda Paper 21A of the May 2021 Board paper. Board members asked the staff to address the following points:

(a) what is the objective for classifying items of income and expenses in the financing category;

(b) what items of income and expenses are excluded from financing applying the criteria in Agenda Paper 21A of the May 2021 Board meeting; and

(c) how should the criteria apply to specific liabilities, for example loans with payments linked to commodity prices.

Staff analysis

18. The analysis is structured as follows:

(a) the objective of classifying items of income and expenses in the financing category of the financing (paragraphs 19–20);

(b) in response to the feedback from the Board in paragraphs 17(b) and 17(c), an analysis of income and expenses arising from the requirements of IFRS Standards (paragraphs 21–52);

(i) approach taken in analysis (paragraphs 22–23);

(ii) results of the analysis (paragraphs 24–28);

(iii) analysis of hybrid contracts (paragraphs 29–32);

(iv) when the embedded derivative is separated from the host liability (paragraphs 33–36);

[4] Agenda paper 21A of the May 2021 Board meeting did not include an entity's own equity in the criterion in paragraph 15(a) of this paper. But the staff explained at that Board meeting that it was necessary to include it in order to capture liabilities such as a liability to purchase own shares.

(v) when the embedded derivative is not separated from the host liability (paragraphs 37–43);

(vi) the effect of fair value options in IFRS 9 on the classification of income and expenses in the financing category (paragraphs 44–49);

(vii) summary of conclusions from the analysis (paragraphs 50–52); and

(c) what items of income and expenses should be classified in the financing category for liabilities that combine financing and another activity (paragraphs 53–60).

Objective of classifying items of income and expenses in the financing category

19. The Basis for Conclusions for the Exposure Draft explains that the purpose of classifying specified income and expenses in a financing category is to facilitate an analysis of an entity's performance independently of how the entity is financed. The Exposure Draft proposed achieving that objective by identifying liabilities that arise from financing activities, the income and expenses for which would be classified in the financing category. The Exposure Draft also proposed that interest expense on other liabilities should be classified in the financing category, essentially for pragmatic reasons, explaining that there are different views on whether such interest expense should be classified as operating or financing—the important thing is to have them in a known place so users can find them, and make adjustments if necessary.

20. The approach in Agenda Paper 21A of the May 2021 Board meeting does not change the objective of facilitating an analysis of an entity's performance independently of how the entity is financed. It also results in substantially the same classification as the proposals in the Exposure Draft. But it approaches the objective in a different way. So the aim of the financing category in the Exposure Draft was effectively to identify a financing activity. However, the analysis in Agenda Paper 21A of the May 2021 Board meeting demonstrated that identifying liabilities from financing activity is not possible. The approach in that paper therefore aimed to identify income and expenses that are financing in nature, by including all income and expenses on liabilities that arise from transactions that involve only the raising of finance, and financing type

items on other liabilities. However, the aim of identifying income and expenses that are financing by nature is constrained by the need to rely on the requirements of IFRS Standards to make such an identification (see discussion in paragraph 23).

Analysis of income and expenses arising from the requirements of IFRS Standards

21. To address the feedback from the Board set out in paragraphs 17(b) and 17(c), the staff have analysed what income and expenses arise from the requirements in IFRS Standards that apply to liabilities.

Approach taken in analysis

22. In that analysis we have assumed that the Board will not specifically require an entity to disaggregate income and expenses beyond the requirements of those Standards for the purpose of classifying income and expenses in the financing category. For example, IFRS 2 does not require an entity to disaggregate the change in the fair value of share-based payments into components depicting service cost, interest expense, remeasurements etc. We have assumed that the Board will not in this project add disaggregation requirements to IFRS Standards to achieve any specific disaggregation. We have made that assumption because:

    (a) it would not be possible to set an overarching requirement in the new standard for identifying financing income and expenses that could be applied consistently with the existing requirements in every IFRS Standard that relates to liabilities, because of the different measurement requirements in the Standards; and

    (b) it is beyond the scope of this project to consider separately the requirements of each IFRS Standard and require specific disaggregation of income and expenses for the purpose of classifying income and expenses in the financing category.

23. The question of disaggregation of income and expenses by an entity beyond that specifically required by a Standard will be discussed in a future Board paper that continues the Board's discussion on the principles of disaggregation. However, the staff do not think that any such disaggregation should affect classification of income

and expenses in the categories in the statement of profit or loss, because of the lack of comparability that might introduce. The lack of comparability could be substantial because of the different ways entities might disaggregate components of income and expenses. For example, if an entity wanted to disaggregate the change in the fair value of a share-based payment into an 'interest expense' which it would classify in the financing category, with the residual fair value change being classified in operating, there could be many ways of calculating what the 'interest expense' would be.

Results of the analysis

24. Appendix A sets out the results of our analysis of the Standards. It demonstrates that, for Standards that set requirements for liabilities other than IFRS 9, almost always:

(a) the transactions covered involve an activity other than financing—that is essentially why a Standard for that topic exists;

(b) the liabilities involve the receipt or return of a non-cash asset (or service); and

(c) as a consequence, all result in income/expenses in some circumstances that are unrelated to financing.

25. The exception is a financing arrangement accounted for applying paragraph B68 of IFRS 15. The liability that arises from such a transaction involves the receipt and return of cash, not any non-cash asset (or service) However, the staff think that classifying such a transaction as involving only financing activities is a faithful representation of the transaction—which would be the outcome applying the criteria discussed in Agenda Paper 21A of the May 2021 Board meeting (set out in paragraph 16 of this paper),

26. The staff therefore conclude that the criteria discussed in Agenda Paper 21A of the May 2021 Board meeting work well in identifying which liabilities outside the scope of IFRS 9 should be classified as arising from transactions that combine the raising of finance with another activity, and for which not all income and expenses should be classified in the financing category. The only liability for which questions might arise on the classification using those criteria is a lease liability with an embedded derivative that is not separated. Such liabilities are discussed in paragraphs 37–43.

27. The analysis of income and expenses relating to liabilities in the scope of IFRS 9 is more complicated. IFRS 9 includes fair value options that result in different measurement for liabilities, and hence in different income and expenses. Paragraphs 44–49 of this paper discuss the effect of these options. In addition, the scope of IFRS 9 includes:
    (a) liabilities that arise from transactions that combine the raising of finance with another activity, for example amounts payable to suppliers with extended credit terms;
    (b) liabilities that arise from transactions that involve no other activity beyond the raising of finance, for example bank loans with fixed repayments; and
    (c) liabilities that arise from a transaction where it is open to question whether they involve another activity beyond the raising of financing, for example hybrid contracts such as loans with repayments linked to commodity prices.
28. The description of the liabilities in paragraphs 27(a) and 27(b) is consistent with how they would be classified using the criteria discussed in Agenda Paper 21A of the May 2021 Board meeting (also set out in paragraph 16 of this paper). Applying those criteria, the liabilities described in paragraph 27(c) would be determined to be arising from transactions that involve no activity other than the raising of finance, because the entity receives cash and returns cash (or its own shares). However, in the light of feedback from Board members at the May 2021 Board meeting that these liabilities might arise from transactions that involve activities other than financing, for example risk management relating to activities other than financing, the staff has analysed these contracts further.

Analysis of hybrid contracts

29. The contracts in question are hybrid contracts with a non-derivative liability host and an embedded derivative. Such contracts can be in the scope of IFRS 9, IFRS 16 or IFRS 17. Our analysis covers liabilities within the scope of IFRS 9 and IFRS 16. Derivatives embedded in insurance contracts in the scope of IFRS 17 are subject to specific requirements in that standard. Hence no questions arise on how the effect of embedded derivatives should be classified.

30. The income and expenses that arise from contracts with embedded derivatives in the scope of IFRS 9 and IFRS 16 depend on whether the embedded derivative is separated from the host contract, and on whether a fair value option applies (see paragraphs 44–49 for a discussion of the effect of the fair value options in IFRS 9).

31. The staff have considered the classification of income and expenses in the financing category when:

    (a) the embedded derivative is separated from the host liability; and

    (b) the embedded derivative is not separated from the host liability.

32. An embedded derivative is separated from a host liability if, and only if, the conditions in paragraph 4.3.3 of IFRS 9 are met. They are:

> 4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:
>
> (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);
>
> (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
>
> (c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

When the embedded derivative is separated from the host liability

33. If the embedded derivative is separated from the host liability:

    (a) the host liability is measured at amortised cost; and

    (b) the separated derivative is measured at fair value through profit or loss.

34. The staff think it would be consistent with the requirements of IFRS 9 to treat the separated components as if they were a stand-alone liability and stand-alone derivative. Accordingly, the criteria discussed in Agenda Paper 21A of the May 2021

Board meeting (set out in paragraph 16 of this paper) would apply to the host liability and the staff recommendation in Agenda Paper 21B would apply to the separated derivative.

35. Treating the embedded derivative separately from the host liability enables its effect to be analysed separately. The outcome is that:

(a) in some cases, an embedded derivative introduces operating (or investing) activities into a transaction that would otherwise be classified as solely financing. For example, consider the situation in which an entity entered into a loan with payments linked to a commodity price because it was exposed to risk relating to that commodity price through its operating activities and used the derivative embedded in the loan to manage that risk. Applying the approach in paragraph 34 of this paper, the loan would be treated as a liability that is solely financing with all income and expenses classified in the financing activity. Applying the approach recommended by the staff in Agenda Paper 21B, the gains and losses on the separated derivative used for risk management would be classified in the operating category because the entity is managing a risk that affects the operating category.

(b) in other cases, as explained in Agenda Paper 21B, the separated derivative itself may be a derivative used for managing risks affecting the financing category. In those cases, the income and expenses from the host liability would be classified in the financing category as would the gains and losses on the separated derivative.

36. Accordingly, the staff think no problems arise with the classification of income and expenses in the financing category when embedded derivatives are separated from the host liability.

When the embedded derivative is not separated from the host liability

37. Applying IFRS 9, an embedded derivative cannot be separated from the host unless specified criteria are met (see paragraph 32 of this paper). As explained in paragraph 22, it is beyond the scope of this project to require additional disaggregation beyond

that required by other Standards. Hence, if the embedded derivative is not separated applying IFRS 9, we need to decide whether:

(a) to ignore the embedded derivative for the purpose of classifying income and expenses, and simply apply the criteria discussed in Agenda Paper 21A of the May 2021 Board meeting (set out in paragraph 16 of this paper);

(b) ignore the host liability for the purpose of classifying income and expenses, and simply apply the criteria recommended for stand-alone derivatives in Agenda Paper 21B of this meeting; or

(c) develop new criteria for such contracts.

38. The staff do not think the approach described in paragraph 37(b) is appropriate because the existence of the host liability is fundamental to the contract.

39. The approach described in paragraph 37(a) results in:

(a) in some cases, effects of the embedded derivative being classified in the financing category when they would have been classified in the operating category had the embedded derivative been separated.

(b) in some cases, effects of the embedded derivative being classified in the operating category when they would have been classified in the financing category had the embedded derivative been separated.

40. Appendix B sets out a summary of the classification of income and expenses for hybrid contracts for which the embedded derivative is not separated, and identifies when the differences described in paragraph 39 occur.

41. Appendix B demonstrates that the approach described in paragraph 37(a) results in some inconsistencies between the classification of the effect of embedded derivatives that are separated and the classification of the effect of those that are not. But equally, the approach described in paragraph 37(c) (creating different criteria for hybrid contracts that are not separated) would inevitably result in some inconsistencies between (a) the classification of some income and expenses for such contracts and (b) the classification of income and expenses on contracts without embedded derivatives or contracts where the embedded derivative is separated. The only way to avoid any inconsistencies is to disaggregate the income and expenses of the entire hybrid

contract into those relating to the host liability and those relating to the embedded derivative—but such disaggregation is not required by IFRS Standards.

42. In addition, developing any different criteria for hybrid contracts that are not separated would add considerable complexity to the requirements. Further, some of the situations that result in the inconsistencies noted in Appendix B are unlikely to occur frequently.

43. The staff conclude that the costs of developing different criteria for hybrid contracts that are not separated would outweigh the benefits. Hence the staff recommend the Board require income and expenses on hybrid contracts that are not separated to be classified using the criteria discussed in Agenda Paper 21A of the May 2021 Board meeting.

The effect of the fair value options in IFRS 9 on the classification of income and expenses in the financing category

44. IFRS 9 includes some options for an entity to measure liabilities at fair value, for example:

    (a) when doing so eliminates or significantly reduces an accounting mismatch or a group of financial liabilities is managed and its performance evaluated on a fair value basis (see paragraph 4.2.2 of IFRS 9); or

    (b) for a hybrid contract designated at fair value through profit or loss applying Section 4.3 of IFRS 9, for example when an entity chooses to measure the contract at fair value rather than separate an embedded derivative that is not closely related to the host (see paragraph 4.3.3(c) of IFRS 9).

45. Applying the options described in paragraph 44(a) to liabilities arising from transactions that meet the cash/own shares for cash/own shares criteria in paragraph 15 of this paper (for example a bank loan with fixed repayments), income and expenses would be recognised in the financing category regardless of whether they arise from measurement at fair value or amortised cost.

46. In contrast, for liabilities arising from transactions that do not meet the cash/own shares for cash/own shares criteria in paragraph 16 of this paper (for example a liability to a supplier with extended credit terms), applying the options in paragraph

44(a) would result in no income and expenses being classified in the financing category (because IFRS 9 does not require an interest expense to be disaggregated from the fair value change), compared to interest expenses if the liability were measured at amortised cost.

47. For the options described in paragraph 44(b):

(a) for contracts with host liabilities that arise from transactions that *meet* the cash/own shares for cash/own shares criteria in paragraph 16 of this paper (for example a bank loan with repayments linked to commodity prices), applying the option in paragraph 44(b) could have an effect on whether income and expenses relating to the embedded derivative are classified in the financing category. If the contract is not measured at fair value in its entirety, the embedded derivative would be measured separately and related income and expenses would be classified in the *operating category* if the embedded derivative were used to manage risk affecting *operating activities*. If the contract is measured at fair value in its entirety, applying the approach recommended in paragraph 43 of this paper, all income and expenses relating to the hybrid contract would be classified in the *financing category*.

(b) for contracts with host liabilities that arise from transactions that *do not meet* the cash/own shares for cash/own shares criteria in paragraph 16 of this paper (for example a liability to a supplier with extended credit terms and payments linked to commodity prices), applying the option in paragraph 44(b) could also have an effect on whether income and expenses relating to the embedded derivative are classified in the financing category. If the contract is not measured at fair value in its entirety, the embedded derivative would be measured separately, and related income and expenses would be classified in the *financing category* if the derivative was used to manage *financing risk*. If the contract is measured at fair value in its entirety, applying the approach recommended in paragraph 43 of this paper, all income and expenses relating to the hybrid contract would be classified in the *operating category*.

48. The staff thinks the effects described in paragraphs 45 and 46 will be relatively rare because usually entities (that are not entities with specified main business activities)

prefer not to measure liabilities at fair value. In addition, the effects in paragraph 47 do not arise on liabilities outside the scope of IFRS 9, such as lease liabilities, because the fair value options do not apply to liabilities outside the scope of IFRS 9. However, the effects in paragraph 47 could arise for liabilities in the scope of IFRS 9, see discussion of derivatives relating to financing activities in Agenda Paper 21B.

49. Nonetheless, as noted in paragraph 22, this project has to rely on the requirements of other standards. The fair value options are in IFRS 9 for good reasons but they will potentially affect presentation as well as measurement and recognition. It is beyond the scope of this project to amend the options for the purposes of classification of income and expenses in the financing category.

Summary of conclusions from analysis of income and expenses from IFRS Standards

50. Based on our analysis, we conclude that the approach set out in Agenda Paper 21A of the May 2021 Board meeting provides a relatively simple and clear approach to the classification of income and expenses in the financing category for liabilities, other than liabilities with embedded derivatives. In addition, for liabilities with embedded derivatives when the embedded derivative is separated from the host, the approach set out in Agenda Paper 21A of the May 2021 Board meeting can be applied without problems to the host liability leaving the separated derivative to be treated consistently with stand-alone derivatives. For liabilities with embedded derivatives that are not separated from the host liability, we acknowledge there are complexities, but think that applying the approach set out in Agenda Paper 21A of the May 2021 Board meeting provides the best pragmatic solution.

51. Hence the staff recommend the Board confirm the approach discussed in the May 2021 meeting, that is:

    (a) to require the following income and expenses to be classified in the financing category of profit or loss:

        (i) all income and expenses from liabilities that arise from transactions that involve only the raising of finance; and

(ii) interest income and expenses from other liabilities (exactly what items of income and expenses this will include is discussed in paragraphs 53–60 of this paper);

(b) to describe transactions that involve only the raising of finance as transactions that involve:

(i) the receipt by the entity of cash, a reduction in a financial liability or an entity's own equity; and

(ii) the return by the entity of cash or an entity's own equity;

52. The staff also recommend, in relation to hybrid contracts with host liabilities and embedded derivatives, the Board require:

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

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

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

Questions for the Board
Q1 Does the Board agree with the staff recommendation set out in paragraph 51(a)?
Q2 Does the Board agree with the staff recommendation set out in paragraph 51(b)?
Q3 Does the Board agree with the staff recommendation set out in paragraph 52?

What income and expenses should be classified in the financing category for liabilities arising from transactions that combine financing with another activity?

53. Appendix A summarises what types of income and expenses are identified by IFRS Standards that cover liabilities. IFRS Standards that cover liabilities differ in the extent to which they require different types of income or expenses to be identified.

For example, IAS 19 identifies expenses to be recognised in profit or loss as current service cost, past service cost, interest cost and settlements and curtailments. In contrast, IFRS 2 does not disaggregate the change in fair value of a liability for share-based payments into any identified expenses. As discussed in paragraph 22, the staff think that the identification of what types of income and expenses arise on liabilities should be determined by the specific requirements of the standards that cover the liabilities.

54. Taking that approach, and given the types of income and expenses identified by the Standards set out in Appendix A, the staff considered how best to capture the items that can be regarded as financing in nature. In particular, the staff considered:

(a) the effects of changes in discount rates (see paragraph 55);

(b) the effects of changes in expectations of cash flows (see paragraphs 56–57); and

(c) fair value changes (see paragraph 58).

55. An effect from changes in discount rates is recognised applying Standards that require a current value measurement based on discounted future cash flows, for example IAS 37, IAS 19 and IFRS 17. Applying IAS 19, the effect is recognised in other comprehensive income. Applying IFRS 17, the effect is included in insurance finance expenses. Applying IAS 37, it is listed together with the unwinding of the discount as amounts that need to be disclosed (paragraph 84(e) of IAS 37). Given these requirements, the staff concluded that to the extent that such effects are identified in a standard and recognised in the statement of profit or loss, they should be classified with interest expense in the financing category.

56. An effect from changes in expectations of cash flows is also recognised applying Standards that require a current value measurement based on discounted future cash flows, again for example IAS 37, IAS 19 and IFRS 17. In addition, such an effect is recognised in some circumstances applying amortised cost measurement in IFRS 9 and applying the measurement required for lease liabilities in IFRS 16. Looking at each of these Standards:

(a) applying IAS 37, such changes in expectations of cash flows could arise from non-financing aspects of the liability, for example increases in the estimate of the cost of restoring environmental damage. The related income and expenses is recognised in the statement of profit or loss, but may be combined with expenses for new liabilities (for increased expectations of cash outflows). The staff conclude these effects should be excluded from the financing category.

(b) for liabilities in the scope of IAS 19 such changes in expectations are included in other comprehensive income, and hence are outside the scope of this project.

(c) liabilities in the scope of IFRS 17 are very likely to be issued by entities with specified main business activities so their analysis is not necessarily relevant for this paper. But in fact the effects of changes in expected cash flows are analysed between those arising from financial risks which are treated as insurance finance income and expenses and those arising from non-financial risks which are treated as insurance service expenses. The staff conclude that the label 'interest expense' appropriately classifies the insurance finance income and expenses that should be classified in the financing category and any other amounts should be excluded from the financing category.

(d) for liabilities in the scope of IFRS 9, the changes in expectations of cash flows could be caused by either changes in financial risks or by changes in non-financial risks (for example on a hybrid contract with an embedded derivative that is not separated because it does not meet the definition of a stand-alone derivative).

(e) for liabilities in the scope of IFRS 16, the effect of changes in expectations of cash flows reflected in the measurement of the lease liability will usually adjust the cost of the right-of-use asset. Expenses will arise only if the adjustment would reduce the right-of-use asset to below zero. The staff conclude that these expenses can be regarded as relating to the right-of-use asset and should therefore be excluded from the financing category.

57. Given this analysis, the staff conclude that excluding from the financing category the effects of changes in estimates of cash flows would give an appropriate classification

for most liabilities. There may be some effects relating to hybrid contracts with embedded derivatives that are not separated that, in principle, would be better classified in the financing category, but as discussed in paragraphs 37–43, the staff recommend not setting specific requirements just for those contracts.

58. Income and expenses from changes in fair value arise for share-based payments (IFRS 2) and contingent consideration in a business combination (IFRS 3), in addition to liabilities in the scope of IFRS 9 measured applying the fair value options (see paragraphs 44–49). These Standards do not specifically require disaggregation of the change in fair value. The question is therefore whether, for liabilities that arise from transactions that are not solely financing, the total change in fair value should be classified in financing, or excluded from financing. The staff concluded that important aspects of an entity's operating activities would be excluded from the operating category if the changes in fair value were included in their entirety in the financing category.

59. The staff therefore concluded that requiring classification in the financing category of 'interest expense and the effect of changes in interest rates, when identified applying the requirements of IFRS Standards,' captures the right population, given the constraint of using the existing requirements of the Standards. The outcome of that approach is set out in Appendix A.

60. Foreign exchange differences are not covered in the analysis in Appendix A because they are not specific to standards that cover liabilities but instead arise on all monetary liabilities applying the requirements of IAS 21. The classification of foreign exchange differences for all liabilities is discussed in Agenda Paper 21C.

Question for the Board
Q4 Does the Board agree that, for liabilities that arise from transactions that are not solely financing, an entity shall classify in the financing category interest expense and the effect of changes in interest rates, when such amounts are identified applying the requirements of IFRS Standards ?

Appendix A—analysis of types of income and expenses arising from IFRS Standards on liabilities

A1 This Appendix is structured as follows:

a. Table 1—income and expenses from liabilities in the scope of IFRS Standards other than IFRS 9

b. Table 2—income and expenses from liabilities in the scope of IFRS 9.

Table 1

Standard	**Examples of liabilities**	**Resources received/returned**	**Measurement of liability**	**Income/expenses identified as interest expense and the effect of changes in interest rates**	**Other income/expenses**
IFRS 2	Cash-settled share-based payments	Receive non-cash asset or service Return cash	FV, initially and subsequently	None	Initial expense Change in FV of liability
IFRS 3	Liabilities as a result of a separate transaction (not part of the exchange)	Accounted for applying other standards			

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
	Liabilities assumed (part of the exchange)	Assessment of what the entity received should be based on what the acquired entity received. Return depends on terms of the liability	Initially FV or applying other standards Subsequently applying other standards	Identified applying other Standards	Initial gain on a bargain purchase Subsequent income/expenses identified applying other Standards
	Contingent liabilities (fair value can be measured reliably)	Receive net assets Return cash/own shares/NCI	Contingent liability is measured at the higher of: (a) the amount that would be recognised in accordance with IAS 37; and (b) the amount initially recognised less, if appropriate, the cumulative amount of income recognised in	Applying IAS 37—interest expense Applying principles of IFRS 15—unlikely to result in income because the amount is unlikely to change. It acts as a minimum amount to be recognised initially.	Applying IAS 37—income/expense from change in carrying amount of contingent liability, other than interest expense Applying principles of IFRS 15—unlikely to result in income because the amount is unlikely to change. It acts as a minimum

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
			accordance with the principles of IFRS 15		amount to be recognised initially.
	Deferred consideration (classified as a financial liability)	Receive net assets Return cash/own shares	Initially FV Subsequently applying other standards	Liability accounted for applying IFRS 9—see table 2	
	Contingent consideration (classified as a financial liability)	Receive net assets Return cash/own shares	Measured at FV	Liability accounted for applying IFRS 9—see table 2	
IFRS 5	Costs to sell a non-current asset held for sale (not a liability but included in B37(d) of ED)	N/A because income and expenses relate to an asset. Included in financing because we do not want to change paragraph 17 of IFRS 5 which requires the increase in the present value that arises from the passage of time to	Measured at present value of costs to sell.	Interest expense	Other changes in the costs to sell.

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
		be presented as a financing cost.			
IFRS 14	Not analysed. We will consider the interaction of our proposals with the rate regulation team.				
IFRS 15	Liabilities where consideration is received in advance of transfer of goods/services (performance obligations)	Receive cash Return goods/services	Transaction price allocated to performance obligations Onerous contracts measured applying IAS 37	Interest expense if there is a significant financing component Interest expense on onerous contract	Revenue Loss on onerous contract
IFRS 15	Consideration received in advance of contract meeting all the criteria in paragraph 9 of IFRS 15	Receive cash Return not yet known, probably goods and services Consideration probably only received in expectation of future goods and services.	Liability is measured at the amount of consideration received from the customer	None	Revenue

Standard	**Examples of liabilities**	**Resources received/returned**	**Measurement of liability**	**Income/expenses identified as interest expense and the effect of changes in interest rates**	**Other income/expenses**
	Repurchase agreements accounted for as a lease	See analysis of IFRS 16 liabilities			
	Repurchase agreements accounted for as financing arrangements	Receive cash Return cash	Liability is measured at the amount of consideration received from the customer	Interest expense	Processing or holding costs (eg insurance, reimbursements to customer for holding the asset) We think these costs are likely to be incorporated into the cost of inventory. If not, they would be similar to incremental expenses related to financing activities, which we will discuss at a future Board meeting.

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
	Assurance type warranties	See analysis of IAS 37 liabilities			
IFRS 16	Lease liability	Receive right-of-use asset Return cash	Lease liability is measured at the present value of the lease payments that are not paid (IFRS 16, para. 26)	Interest expense from unwinding of discount	Income/expense due to reassessment (if carrying amount of right-of-use asset is zero) Gain/loss from lease modification (if decrease in scope of lease)
	Sale and leaseback transaction (financing arrangement; transfer of the asset is <u>not</u> a sale)	Financing arrangement accounted for applying IFRS 9			
	Sale and leaseback transaction (lease	See "Lease liability"			

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
	liability; transfer of the asset is a sale)				
IFRS 17	Insurance contract liabilities Probably only issued by entities with specified main business activities	Receive cash Return cash and insurance contract services	Current estimate of future cash flows (fulfilment cash flows) plus unearned profit (contractual service margin)	Insurance finance income and expenses	Insurance revenue Insurance service expenses
IAS 12	Current tax liabilities	Non-exchange transaction Cash returned	Amount expected to be paid. Discounted if effect material.	Unwinding of the discount	Tax expense
	Deferred tax liabilities (including effect of uncertain tax treatments).	Non-exchange transaction Cash returned	Temporary difference measured at tax rate expected to apply when temporary difference reverses. Not discounted.	None	Tax expense

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
	We will consider interest on current tax and on uncertain tax positions at a future meeting				
IAS 19	Defined benefit liabilities	Receive employee service Return cash	Present value of best estimate of ultimate cost of providing benefits, subject to effect of asset ceiling.	Net interest cost	Service cost Settlements and curtailments Remeasurements (included in other comprehensive income)
IAS 20	Government Grants	Non-exchange transaction Receive cash Entities receive government grants because of their operating activities, not because of their financing.		Nothing	All changes
IAS 21	The treatment of changes in foreign exchange rates is discussed in AP21C				

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
IAS 29	The treatment of the effects of inflation will be discussed at a future Board meeting.				
IAS 37	Long-term provisions not capitalised as part of cost of asset	Receive service (or expense related to past event) Return cash	Best estimate of expenditure required to settle the present obligation, including the effect of risks, uncertainties and the time value of money Remeasured using current assumptions NB effect of risks (financial and non-financial) and inflation can be in either the discount rate or the estimates of cash flows).	Unwinding of discount rate and the effect of changes in the discount rate (Based on disaggregation required to be disclosed by IAS 37 paragraph 84)	Additional provisions, including increases to existing provisions Amounts used (no resulting income or expense) Unused amounts reversed (Based on disaggregation required to be disclosed by IAS 37 paragraph 84)

Standard	Examples of liabilities	Resources received/returned	Measurement of liability	Income/expenses identified as interest expense and the effect of changes in interest rates	Other income/expenses
	Decommissioning liabilities capitalised as part of the cost of an asset	Receive asset Return cash	As above but changes other than the unwinding of a discount rate adjust the cost of an asset, to the extent they do not reduce the asset to below zero. Increases in the carrying amount of an asset may trigger impairment test	Unwinding of the discount	Decreases in liability that exceed the carrying amount of the asset Impairment loss on asset

A2 Financial liabilities are measured at amortised cost except if measured at fair value through profit or loss in accordance with IFRS 9, paragraph 4.2.1 or designated at fair value through profit or loss in accordance with IFRS 9, paragraph 4.2.2.

Table 2

Type of liability (para 27)	**Examples of liabilities**	**Resources received/returned**	**Income/expenses identified as interest expense**	**Other income/expenses**
Liabilities that arise from transactions that combine the raising of finance with another activity	Payables to suppliers with or without extended credit terms	Receive inventory or service Return cash	Amortised cost: Interest expense from unwinding of discount	Amortised cost: Income (or reduction of carrying amount of inventory) due to subsequent price reductions FV: Gain/loss from changes in fair value (eg change in credit risk)
Liabilities that arise from transactions that involve no other activity	Supply Chain Financing Arrangement* * Some arrangements do <u>not</u> result in a trade	Receive reduction in financial liability Return cash	Amortised cost: Interest expense from unwinding of discount	Amortised cost: Income from other changes (if any) FV:

Type of liability (para 27)	Examples of liabilities	Resources received/returned	Income/expenses identified as interest expense	Other income/expenses
beyond the raising of finance	payable being derecognised (and a financial liability being recognised)			Gain/loss from changes in fair value (eg change in credit risk)
	Bank loans Corporate bonds with fixed cash payments Promissory notes with fixed cash payments Perpetual debt (classified as a liability) Interest-free debt	Receive cash Return cash	Amortised cost: Interest expense from unwinding of discount	Amortised cost: Transaction costs not directly attributable Modification gain/loss due to re-estimation of cash flows FV: Transaction costs Gain/loss from changes in fair value

Type of liability (para 27)	Examples of liabilities	Resources received/returned	Income/expenses identified as interest expense	Other income/expenses
	Mortgages			
	Share-settled bonds	Receive cash Return equity	Amortised cost: Interest expense from unwinding of discount	FV: Gain/loss from changes in fair value
	Obligation to purchase own equity	Receive equity Return cash	Amortised cost: Interest expense from unwinding of discount	FV: Gain/loss from changes in fair value
	Puttable instrument (classified as a liability), eg obligation entitling holder to a pro rata share of entity's net assets on liquidation	Receive cash Return cash	Amortised cost: Interest expense from unwinding of discount	FV: Gain/loss from changes in fair value
Liabilities that arise from a	Hybrid contract where embedded derivative is	Receive cash Return cash	Amortised cost: Interest expense from unwinding of	Amortised cost:

Type of liability (para 27)	Examples of liabilities	Resources received/returned	Income/expenses identified as interest expense	Other income/expenses
transaction where it is open to question whether they involve another activity beyond the raising of financing	not separated, eg (i) corporate bonds with payments depending on interest rate or (ii) inflation-linked corporate bonds		discount of hybrid contract	Modification gain/loss due to re-estimation of cash flows of hybrid contract FV: Gain/loss from changes in fair value of hybrid contract
	Hybrid contract where embedded derivative is separated, eg (i) corporate bonds with payments depending on commodity prices or (ii) option to convert debt to equity	Receive cash Return cash or equity	Amortised cost: Interest expense from unwinding of discount of host liability	FV: Gain/loss from changes in fair value of separated (embedded) derivative

Appendix B—analysis of the classification of income and expenses arising from hybrid contracts for which the embedded derivative is not separated

B1. This Appendix summarises the classification of income and expenses arising from hybrid contracts with host liabilities for which the embedded derivative is not separated. The summary identifies whether there could be any inconsistency with the classification of the effect of the embedded derivative were that derivative separated.

B2. The analysis covers liabilities within the scope of IFRS 9 and IFRS 16. The other IFRS Standard that covers liabilities with embedded derivatives is IFRS 17. Derivatives embedded in insurance contracts are not separated applying IFRS 9, or IFRS 17. IFRS 17 has specific requirements relating to the classification of income and expenses from insurance contracts, including any embedded derivatives, as insurance finance income or expenses or insurance service expenses.

IFRS 16 lease liabilities

B3. Lease liabilities do not meet the cash/own shares criteria set out in paragraph 16. Lease liabilities might include an embedded derivative. If the embedded derivative does not meet the criteria in IFRS 9 to be separated from the host liability, its effect on the lease liability will be measured applying the requirements of IFRS 16. A change in the lease liability caused by a change in the effect of an embedded derivative would be treated as a reassessment of the lease liability, which applying the approach in the May 2021 Board paper, would be classified in the operating category (see paragraph 56(e) of this paper). Such an embedded derivative is not permitted to be separated, but if it were, a change in its value could be treated as financing if it were used to manage risk from financing activities.

IFRS 9 liabilities that do not meet the cash/own shares criteria set out in paragraph 16

B4. IFRS 9 liabilities that do not meet the cash/own shares criteria set out in paragraph 16 might include an embedded derivative. That embedded derivative would not be separated from the host liability if it does not meet the criteria for separation in IFRS 9. The entire liability might be measured at fair value or amortised cost.

B5. If the liability is measured at fair value, the effect of the embedded derivative will be part of the change in fair value. Applying the approach in the May 2021 Board paper, that change in fair value would be classified in the operating category. Such an embedded derivative is not permitted to be separated, but if it were, a change in its value could be treated as financing if it were used to manage risk from financing activities.

B6. If the liability is measured at amortised cost, the effect of a change in the liability caused by a change in the effect of an embedded derivative would be treated as a modification gain or loss, which applying the approach in the May 2021 Board paper would be classified in the operating category (see paragraph 56(d)) of this paper. Such an embedded derivative is not permitted to be separated, but if it were, a change in its value could be treated as financing if it were used to manage risk from financing activities.

IFRS 9 liabilities that meet the cash/own shares criteria set out in paragraph 16

B7. IFRS 9 liabilities that meet the cash/own shares criteria set out in paragraph 16 might include an embedded derivative. That embedded derivative would not be separated from the host liability if it does not meet the criteria for separation in IFRS 9. The entire liability might be measured at fair value or amortised cost.

B8. If the liability is measured at fair value, the effect of the embedded derivative will be part of the change in fair value. Applying the approach in the May 2021 Board paper, that change in fair value would be classified in the financing category. Such an embedded derivative is not permitted to be separated, but if it were, a change in its value could be treated as operating if it were used to manage risk from operating activities.

B9. If the liability is measured at amortised cost, the effect of a change in the liability caused by a change in the effect of an embedded derivative would be treated as a modification gain or loss, which applying the approach in the May 2021 Board paper would be classified in the financing category. Such an embedded derivative is not permitted to be separated, but if it were, a change in its value could be treated as operating if it were used to manage risk from financing activities.