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Project	**Primary Financial Statements**
Paper topic	Classification of foreign exchange differences

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Objective

1. This paper sets out staff analysis and recommendations relating to the proposals in the Exposure Draft *General Presentation and Disclosures* on the classification in the categories in the statement of profit or loss of foreign exchange (FX) differences.

2. The feedback discussed in this paper is an extract from Agenda Paper 21B of the December 2020 Board meeting of feedback that relates to classification of FX differences, with additional detail.

Summary of staff recommendation

3. The staff recommend retaining the Board's proposal in paragraph 56 of the Exposure Draft with one change—to add an exemption when classification in the categories in the statement of profit or loss involves undue cost or effort. This means, to require an entity to classify FX differences in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the FX differences—unless there is undue cost or effort, in which case the entity would classify the FX differences on the item in the operating category.

Structure of the paper

4. This paper is structured as follows:
   (a) the proposal in the Exposure Draft;
   (b) feedback;
   (c) staff analysis; and
   (d) staff recommendation and question for the Board.
5. The paper includes three appendices:
   (a) Appendix A—Additional analyses
   (b) Appendix B—Fieldwork findings
   (c) Appendix C—Analysis of current practice

Proposal in the Exposure Draft

6. Paragraph 56 of the Exposure Draft proposed an entity classifies FX differences included in profit or loss applying IAS 21 in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the FX differences.[1] For example, FX differences relating to accounts receivable would be classified in the operating category whereas FX differences on foreign currency denominated loans would be classified in the financing category (unless those loans relate to provision of finance to customers and are classified as operating, as discussed in paragraphs BC62–BC69 of the Exposure Draft).

Feedback

Feedback from comment letters and outreach

7. Some respondents did not comment on the Board's proposal for classification of FX differences and a few commented but did not express a view. Of the respondents who expressed a view, many disagreed on the basis that the costs of applying the proposal would exceed its benefits and a few others noted the proposal is inconsistent with

[1] See paragraphs B39 and BC90-BC92 of the Exposure Draft for additional information related to the proposal.

their current practice. A few other respondents from various stakeholder groups agreed with the proposed classification, stating the proposals were conceptually sound, noting that the practical challenges are primarily related to system changes.

8. The respondents who disagreed on the basis that implementation costs would exceed benefits were of the view that the proposal would be complex and costly to apply. They said allocating FX differences in the categories for some entities would mean costly enhancements to reporting systems because they currently capture all FX differences in a single location. Some entities do so because capturing FX differences in aggregate at an entity level facilitates a view of net exposure which is then managed centrally (eg central Treasury). Instead, they said an option to classify all FX differences on a single location (eg the operating category) would be more appropriate for their circumstances.

9. Others disagreed noting it would be inconsistent with their practice relating to FX:

   (a) a few respondents said the proposal would prevent them from presenting the net effect resulting from the 'natural' risk management within the same category of the statement of profit or loss, between the FX differences on foreign currency assets and on liabilities that are *managed together*. [2] Proposed classification in this situation fails to reflect the natural offset within the same category, thus reducing usefulness of information. For example, if the entity considers a trade receivable in foreign currency as managed together with a borrowing on the same foreign currency, it will want to classify their FX differences in the same category in the statement of profit or loss to reflect the offset in the category. However, applying the proposal, the entity would classify FX differences on the receivable in the operating category, while the FX differences on the borrowing in the financing category. [3] These entities said, the Board should allow an accounting policy choice to accommodate these situations.

[2] By 'managed together', respondents meant there is a relationship between items. For example, the entity decided to borrow in a particular foreign currency to offset FX differences in revenues from sales in that same foreign currency.
[3] Unless one of the entity's main business activities is providing financing to customers in which case it would be included in the operating category

(b) a few other respondents who present expenses in the statement of profit or loss by function rather than by nature, said allocating FX differences in categories would require them to classify FX differences by nature because FX differences cannot be allocated to functions. This would be inconsistent with paragraph B46 of the Exposure Draft which prevents entities from providing an analysis of expenses classified in the operating category using a mixture of the nature of expense method and the function of expense method. We do not address this feedback in the paper, and will instead discuss it together with other feedback relating to analysis of expenses by nature and by function in future papers.

10. A few respondents also said that allocating FX differences to categories would make operating profit appear volatile, and thus FX differences should be classified outside the operating category (eg in the financing category). They also questioned the usefulness of information to the users of financial statements from allocating the FX differences in categories because of the view that FX differences have no predictive value, and thus do not improve analyses of users.

11. Some respondents requested additional time for implementation and more examples and guidance. For example, some asked the Board to provide application guidance relating to the classification of FX differences on intercompany transactions.

Feedback from users of financial statements

12. There was no comment letter feedback from users of financial statements for this proposal. In the following paragraphs, we provide feedback from the October 2020 joint meeting of the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF). We also summarise points relevant to the classification of FX differences included in a CFA report which sets out investor perspectives on non-GAAP financial measures. [4]

13. Many CMAC members said that a lack of comparability in the classification of FX differences in the statement of profit or loss would have no effect on their analyses,

[4] Page 54 of the CFA Institute report *Investor uses, expectations, and concerns on non-GAAP financial measures* which can be accessed here.

provided relevant information was disclosed. Given the preparers' potential difficulties, these members said, entities should be able to classify FX differences in a way that reflects their approach to considering FX.

14. However, some CMAC members said that information about an entity's exposure to FX risk, how it manages that risk, and whether that risk management is successful is important to their analyses and that current disclosures do not always provide sufficient information. These members said that the Board's proposal would contribute to a better understanding of the effects of FX on an entity's financial performance.

15. The CFA report notes that classifying FX differences outside the operating category is understandable if the underlying foreign currency exposure relates to the investing or the financing activities. However, such adjustment becomes contentious if it relates to exposures from operating activities (eg export sales or imports of production inputs). In this case, classifying FX differences outside the operating category may be considered a misrepresentation of the performance of any business model that has foreign currency risk exposures through its operating activities. The report notes that lack of management control is sometimes cited as the reason for classifying FX differences outside the operating category ie excluding from the operating profit. The report questions the basis of that rationale because it overlooks the fact that management has a choice and control over the foreign countries in which an entity can trade, borrow, or invest. The report notes that FX differences are no less real than other income and expenses.

Staff analysis

16. Consistent with the Exposure Draft, the scope of FX differences discussed in this paper is limited to those arising in the statement of profit or loss from translating foreign currency monetary items into an entity's functional currency in accordance with paragraphs 28 and 30 of IAS 21 *The Effects of Changes in Foreign Exchange Rates.* Some IFRS Standards already specify that FX differences should be included alongside particular transactions[5]. This analysis does not override those requirements.

[5] For example, paragraph 6(e) of IAS 23 *Borrowing Costs* states that borrowing costs may include FX differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

17. In this section we provide the staff analysis on:

(a) the Board's objective (paragraphs 18–19);

(b) whether the Board needs to change the proposal (paragraphs 20–23); and

(c) alternative approaches (paragraphs 24–37).

The Board's objective

18. In paragraph BC92 of the Exposure Draft, the Board notes that it developed the proposal with the objective of providing a faithful representation of an entity's business activities. For example, in the Board's view, an entity would provide an incomplete picture of the performance of its main business activities if it excluded FX differences related to the main business activities from operating profit or loss and classified them in a different category. We continue to agree with this objective and note that the respondents who disagreed with the proposal mostly did so on the basis of costs of implementation and not its objective.

19. We also considered whether the Board should introduce additional objectives and concluded it was not necessary, for the following reasons:

(a) as discussed in paragraph 14, some CMAC members said that information about an entity's exposure to FX risk, how it manages that risk, and whether that risk management is successful is important to their analyses. We note that, to a large extent, the existing disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*[6] could provide such information. Also, considering such disclosures would go beyond the scope of an IFRS Standard on General Presentation and Disclosures. Hence, we think no addition to the Board's objective is needed to accommodate that need for information.

(b) as discussed in paragraph 9(a), a few respondents suggested the objective of the proposals should be to reflect 'natural' risk management ie align classification categories for FX differences arising on translation of items that are managed together. We disagree with such approach for the reasons noted

[6] Paragraph 22A of IFRS 7 applies to risk exposures that an entity decides to hedge and for which hedge accounting is applied. In addition, paragraphs 31–42 of IFRS 7 require information about nature and extent of risks arising from financial instruments.

in paragraph BC102 of the Exposure Draft. That is, it may be costly for an entity to identify the categories affected by the FX risk managed and monitor whether the entity is holding the financial instrument for that risk management. This is because entities may hold non-derivative financial instruments for multiple purposes, including risk management. We note that there is no new information provided by these respondents that was not previously considered by the Board.

(c) as discussed in paragraph 10, a few respondents suggested the objective should be to avoid volatility of operating profit. We note that the Board's objective of classification of income and expenses in the operating category is not to the avoid the volatility but to provide complete depiction of operating profit. We therefore do not think this should be added to the objective.

Whether the Board needs to change the proposal in the Exposure Draft?

20. Feedback described in paragraphs 7–15 suggest that classifying FX differences as proposed by the Board has conceptual merits and generally provides faithful representation of the effects of FX differences on the entity's financial performance. However, respondents describe challenges faced by some entities when the costs of system enhancements needed to acquire information for allocating FX differences into categories may outweigh its benefits.

21. We are sympathetic to these respondents' concerns. In light of that feedback, and considering comments from users of financial statements, we think the Board should consider a possible amendment to the proposal in the Exposure Draft. The amendment should assist the affected entities to avoid undue cost or effort in allocating FX differences in categories.

22. However, in amending the proposal, the Board should be mindful to not impose undue changes for entities that currently allocate FX differences in categories. As noted from fieldwork findings (see paragraph B4 of Appendix B), some entities already allocate FX differences in categories of the statement of profit or loss. This means that a complete change of the Board's proposal (eg requiring classification of all FX differences in a single category) would impose change upon them, requiring them to provide less useful information to users of financial statements. For this reason, we

did not recommend an approach that would require classification of all FX differences in a single category in the statement of profit or loss.

23. We also did not consider an approach that would reflect the entity’s way of managing FX differences, suggested by CMAC members in paragraph 13, because that would be inconsistent with the Board’s general approach to classification of income and expenses in the categories in the statement of profit or loss.

Alternative approaches

24. In light of these observations, we identified two approaches to consider:

    (a) Approach A—to classify FX differences as proposed in the Exposure Draft, unless such classification involves undue cost or effort, in which case an entity would classify the FX differences on the item in the operating category (paragraphs 30–33); and

    (b) Approach B—to make an accounting policy choice to either classify all FX differences in the operating category, or classify FX differences as proposed in the Exposure Draft—that is, in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the FX differences (paragraphs 34–36).

25. The staff consider the operating category to be the residual category or the default category. Paragraphs 26–29 explain why.

Why consider the operating category for FX differences?

26. We acknowledge that any residual or default category the Board would specify may result in arbitrary classification and cause the other categories to be incomplete. However, if the Board provides an exemption to address the cost concerns of some entities for allocating FX differences in categories, it needs to specify a category for classifying FX differences when that exemption is applied.

27. We think that category should be the operating category because:

    (a) classifying FX differences related to an entity’s operations outside the operating category would result with an incomplete operating profit. This would significantly reduce usefulness of the operating profit as a measure of entity's performance, thus affecting analyses performed by users of financial statements.[7] See also the perspectives of some users of financial statements summarised in paragraph 15.

(b) it is consistent with the Board's definition in the Exposure Draft of the operating category as a residual or a default category.

28. Some stakeholders may be of the view that the financing category should be the residual or the default category for FX differences, so that it achieves greater consistency with the current practice of some entities who classify all FX differences in the financing category. We note that a few respondents who suggested the financing category did so on the basis of avoiding volatile operating profit. We disagree with this argument for the reasons noted in paragraph 19(c).

29. In addition, we have not identified evidence to suggest that the financing category is the appropriate category to classify *all* FX differences. Our review of financial statements for a sample of non-financial entities suggests that the primary source of exposures to foreign currency risk differs amongst entities (see Appendix C to this paper). That is, while many entities report the largest portion of FX differences in relation to their financing activities, some others report most or all FX differences in relation to their sales and purchases ie operating activities.

Approach A—as proposed in the Exposure Draft unless it involves undue cost or effort, then operating category

30. Approach A would require an entity to classify FX differences as proposed in the Exposure Draft—that is, classify in the same category of profit or loss as the income and expenses from the items that gave rise to the FX differences—unless it involves undue cost or effort, in which case the entity would classify the FX differences on the item in the operating category.

31. Under approach A, an entity would classify all FX differences included in profit or loss in categories, except for the FX differences on the items for which such classification involves undue cost or effort. Undue cost or effort assessment is specific

[7] As described in the Agenda Paper 21A for the March 2021 Board meeting, some respondents explained they consider operating profit as an important measure that provides relevant information to users. Some users explained they use operating profit in ratio analyses—for example in analysing operating margin—and as a starting point for forecasting in valuation models.

to the facts and circumstances related to the item under the assessment. In doing this assessment, an entity would consider information that is reasonably available without undue cost or effort—if an entity already has, or could easily and without significant expense or effort, acquire the information necessary to allocate the FX differences into categories.

32. The advantages of this approach are that it:

(a) contributes to faithful representation of the effects of the FX differences on the entity's financial performance. To a large extent, it retains the benefits of the Board's proposal in that classifying FX differences in the same category as the income and expenses from the underlying item provides better and more complete information about an entity's business activities. It would therefore meet the Board's objective described in paragraph 18.

(b) addresses respondents' concerns about significant costs. The addition of undue cost or effort exemption is intended to assist preparers in assessing whether the costs of allocating FX differences for particular items exceed the expected benefits to users of financial statements.

(c) avoids the risk of unintended consequences. It avoids the risk that addressing the issues raised by some respondents inadvertently imposes change on other entities ie the entities that already allocate FX differences in categories, who are thus already providing useful information to users of their financial statements.

33. The disadvantages of this approach are that it:

(a) requires a cost-benefit assessment to be made by entities. Some preparers may argue this assessment is a high hurdle and thus does not entirely address their concerns. This is because of the subjectivity involved in making such assessment, which can increase auditing costs. That said, the staff note that other IFRS Standards[8] already include requirements based on benefits and cost or other similar thresholds. Also, paragraph 58 of the Exposure Draft proposed undue cost or effort exemption for non-designated derivatives. As noted in the

[8] For example, in applying the expected credit loss impairment model, IFRS 9 requires an entity to consider all reasonable and supportable information that is available without undue cost or effort.

Agenda Paper 21B for this Board meeting, feedback for that proposal did not raise significant application concerns.

(b) loss of comparability. An exemption based on undue cost or effort would also reduce comparability between entities.

Approach B—accounting policy choice to either classify all FX differences in the operating category or as proposed in the Exposure Draft

34. Approach B is applied in an ‘all or nothing’ basis. An entity would either make an accounting policy choice to classify *all* FX differences in the operating category (ie single location), or to classify FX differences as proposed in the Exposure Draft. In which case it would classify FX differences in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the FX differences.

35. The advantages of approach B are:

(a) it is easier to apply. Applying this approach entities could choose to classify all FX differences in the operating category (ie single location). This choice would avoid the costs and complexity associated with allocating FX differences to categories. This would be consistent with some entities’ practice of reporting FX differences in a single location, and consistent some feedback (see paragraph 8). Compared to the approach A, an entity that chooses to classify all FX differences in the operating category under approach B would not be required to meet the undue cost or effort exemption before using the default category ie operating category.

(b) allows entities to make an accounting policy choice to allocate FX differences in categories. This means that entities who would like to provide useful information by allocating FX differences to categories as proposed in the Exposure Draft, can still do that.

36. The disadvantages of approach B are that:

(a) it does not necessarily result in faithful representation of the effects of FX differences on the entity’s financial performance. Applying approach B could result in an entity classifying *all* FX differences in the operating category even when they arise from the translation of debt instruments or investments. This would make the investing and financing categories incomplete. Overall, it could reduce the usefulness of information about operating profit. Therefore, it may not meet the Board's objective in paragraph 18.

(b) the availability of an accounting policy choice would increase diversity amongst entities. This would reduce comparability amongst entities and the usefulness of information provided to users of financial statements.

(c) may incentivise entities to choose to classify all FX differences in the operating category because it is simpler, even when information for allocating in categories would be available without undue cost or effort.

Consideration of approaches in particular circumstances

37. Appendix A to this paper provides additional analyses of these approaches. Specifically, it discusses:

(a) the interaction of approach A and approach B with the Board's on-going discussion on classification in the financing category (see Agenda Paper 21A for this Board meeting), concluding that the approach A works better.

(b) the issue raised by respondents relating to classification of FX on intercompany balances (discussed in paragraph 11), concluding that entities would have to apply judgement in classification using either approach.

Staff recommendation and question for the Board

38. The staff recommend approach A because the classification outcome applying this approach strikes the appropriate balance between contributing to a faithful representation of the effects of FX differences in the entity's financial performance (thus meeting the Board's objective in paragraph 18), and responding to the cost concerns raised by some respondents.

Question for the Board
Does the Board agree with the staff recommendation to require entities to classify FX differences included in profit or loss in the same category of the statement of profit or loss as the income and expenses from the items that gave rise to the FX differences—unless there is undue cost or effort, in which case the entity would classify the FX differences on the item in the operating category?

Appendix A—Additional analyses

Interaction with the Board's on-going discussion on the financing category

A1. At its May 2021 meeting, the Board first discussed an approach for classification of income and expenses in the financing category. Applying that approach:

(a) all income and expenses from *liabilities* that arise from transactions that involve only *raising finance* would be classified in the financing category. For example, this would include any FX differences on those liabilities; and

(b) interest income and expenses from *other liabilities* would be classified in the financing category.

A2. In Agenda Paper 21A for this Board meeting the staff recommend finalising this approach for classification of income and expenses on the financing category. In paragraphs A3–A8, we analyse the interaction between the approach for the financing category and the approaches for classification of FX differences discussed in this paper.

A3. Applying approach A (as described in paragraphs 30–33) an entity would be required to classify FX differences in the same category as the income and expenses from the item that gave rise to the FX, unless such classification involves undue cost or effort, in which case the operating category is used. Classifying FX differences in the same category as the income and expense from the underlying item enables an entity to achieve classification outcomes that faithfully reflect the effects of the FX differences on the entity's financial performance.

A4. Accordingly, applying approach A, the FX differences that arise from translation of a liability that involve *only raising finance* would be classified in the financing category[9] because that is the category for all income and expenses arising from the liability. This is consistent with the example provided in paragraph B39(b) of the

[9] Unless income and expenses are generated in the course of entity's main business activities, in which case such income and expenses are instead classified in the operating category.

Exposure Draft relating to FX differences on a debt instrument issued by the entity, that is denominated in a foreign currency.

A5. Similarly, for *other liabilities*, an entity applying approach A would classify FX differences in the category that faithfully reflects the effects of FX differences on the entity's financial performance. For example:

(a) consistent with paragraph B39(a) of the Exposure Draft, an entity would classify FX differences on a trade payable (not negotiated on extended credit terms) in the same category as the expenses for the purchase of the goods—that is, normally the operating category.

(b) an entity would classify FX differences on a lease liability, which typically gives rise to no expenses other than interest expense, in the same category as the interest expense—that is, the financing category.

A6. For liabilities that involve activities in addition to financing, there may be cases in which income and expenses are classified in financing and another category, say operating. In such cases, an entity would use its judgement to decide in which category in the statement of profit or loss to classify the FX differences to give the most complete picture of the respective activities.

A7. We think the classification outcomes applying approach A works well with the approach to the classification of income and expenses in the financing category described in paragraph A1. Approach A provides exemption for cases when classification involves undue cost or effort. We expect that it would be unlikely for the classification of FX differences on liabilities that involve only raising finance to involve undue cost or effort. Further, if the classification of FX differences on liabilities that involve financing and another activity involves undue cost or effort, we think it is consistent with the approach in the Agenda Paper 21A for this Board meeting that the default category for such liabilities is the operating category.

A8. In contrast to the approach A, the classification outcomes applying approach B (as described in paragraphs 34–36) could be inconsistent with the approach on the financing category. Under approach B an entity may choose to classify all FX differences (including those from liabilities that involve only the raising of finance) in the operating category. This would not provide a faithful representation of an entity's business activities, thus would not meet the Board's objective (see paragraph 18).

Classification of FX differences on intercompany balances

A9. We considered feedback requesting application guidance on classification of FX differences on intercompany balances (see paragraph 11). This issue arises when the intercompany balances in the statement of financial position and the related income and expenses are eliminated in consolidation, but the FX differences remain. In this case, respondents asked what category to classify the FX differences. We note that this issue is not new. Entities that currently allocate FX differences to categories in the statement of profit or loss apply judgement to decide in which category in the statement of profit or loss to classify FX differences to give the most complete picture of the respective activities. Alternatively, an entity applying approach A may assess that the undue cost or effort exemption is met because of the cost and effort of acquiring information to support classification in another category, thus classifying such FX differences in the operating category.

A10. Applying approach B, a group entity would classify the FX differences on intercompany balances in the operating category if the entity made an accounting policy choice to classify all FX differences in the operating category. Otherwise, if it made the accounting policy choice to classify FX differences as proposed in the Exposure Draft, the group would apply judgement to decide in which category in the statement of profit or loss to classify FX differences to give the most complete picture of the respective activities.

Appendix B—Fieldwork findings

B1. The following paragraphs are an extract from Agenda Paper 21B of the December 2020 Board meeting of fieldwork findings that relate to classification of FX differences.

B2. Potential systems and process changes required to apply the proposals for classifying FX differences varied significantly between participants. Some participants said that information was not available in current systems to classify FX differences in the categories proposed in the Exposure Draft. For example, many of the participants that did not have the available information on the underlying sources of FX differences said this was because they managed these items on a net basis in a central treasury function.

B3. Some participants said that significant changes to systems and processes would be required to apply the proposals for FX differences. For example, one participant said that the changes would delay their ability to implement the proposals by at least a year.

B4. In contrast, some participants said that no changes to systems or processes would be required to classify FX differences in the categories proposed in the Exposure Draft because their existing systems already track the underlying sources.

Appendix C—Analysis of current practice

C1. Although IFRS Standards do not currently require separate operating, investing and financing sections in the statement(s) of financial performance, many (non-financial) entities present an operating and a financing section.

C2. We did a desktop review of financial statements of 25 non-financial entities to see what monetary items typically gave rise to the FX differences for the period (ie item that are operating, investing or financing). If items in different categories gave rise to FX differences, we reviewed the FX differences recognised in the statement of profit and loss to assess whether the largest amount of FX differences were reported in the operating or in the financing category. We found that:

(a) most entities allocate FX differences between the operating and the financing category. Some entities classify all FX differences in financing category. This included an entity who reported its exposures to foreign currency risk are mostly in relation to its sales. Nonetheless, it classified the FX differences in the financing category.

(b) many entities in the sample classified a larger amount of FX differences in financing category. In contrast, some entities operating in international markets, classified a larger amount of FX differences in operating due to their foreign currency sales and purchases.