IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 1 and IFRS 9 — Presentation of interest revenue for particular financial instruments**		
Paper topic	Initial consideration		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® Update. The approval of a final Interpretation by the Board is reported in IASB® Update.

Introduction

1. The IFRS Interpretations Committee (Committee) received a request about the effect of the consequential amendment that IFRS 9 *Financial Instruments* made to paragraph 82(a) of IAS 1 *Presentation of Financial Statements*. That consequential amendment requires an entity to present separately, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method. The submitter asked whether that new requirement affects the presentation of fair value gains or losses on particular derivative instruments.

2. The objective of this paper is to:
   (a) provide the Committee with a summary of the matter;
   (b) present our analysis; and
   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) staff analysis and assessment against the Committee's agenda criteria; and

   (c) staff recommendation.

4. There are two appendices to this paper:

   (a) Appendix A—Proposed wording of the tentative agenda decision; and

   (b) Appendix B—Submission.

Background information

5. Paragraph 82 of IAS 1 sets out information to be presented in the profit or loss section of the statement of comprehensive income or in the statement of profit of loss. IFRS 9 amended that paragraph as follows (new text is underlined):

   > In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:
   >
   > (a) revenue<u>, presenting separately</u>:
   >
   > (i) <u>interest revenue calculated using the effective interest method</u>…

6. The submitter asks whether that consequential amendment to paragraph 82(a) of IAS 1 affects the presentation of fair value gains and losses on 'trading derivatives'. The submitter describes a 'trading derivative' as a derivative instrument that is not part of a designated and effective hedging relationship (applying the hedge accounting requirements in IFRS 9 or IAS 39 *Financial Instruments: Recognition and Measurement*) and notes that such derivative instruments are measured at fair value through profit or loss (FVPL). The submitter asks whether the consequential amendment made by IFRS 9 to paragraph 82(a) of IAS 1 prohibits an entity from presenting particular cash flows

on such derivatives (for example, the accrued and realised cash flows on an interest rate swap) as ‘interest revenue’ in profit or loss, separately from other movements in fair value.

7. The submitter notes there are different views in practice about the meaning of that new presentation requirement in paragraph 82(a) of IAS 1.

Staff analysis and assessment against the Committee’s agenda criteria

Outreach

8. We decided not to perform outreach on this request because the matter relates to a new presentation requirement in IAS 1 that is not yet effective. Additionally, because the request relates to an amendment that IFRS 9 made to IAS 1 and thus is effective for annual periods beginning on or after 1 January 2018, we considered it to be urgent in nature and decided to bring it to the Committee’s November 2017 meeting.

9. With those factors in mind, the scope of this agenda paper is intentionally narrow and addresses *only* the consequential amendment that IFRS 9 made to paragraph 82(a) of IAS 1. We have not analysed, nor have we presented a staff view on, other presentation requirements in IAS 1 or broader matters related to the presentation of other ‘interest’ amounts (or ‘net interest margin’) in the statement of comprehensive income. The amendment that IFRS 9 made to paragraph 82(a) of IAS 1 did not affect those matters.

What does IAS 1 say?

10. As described in paragraph 5 of this paper, the amendment made by IFRS 9 to paragraph 82(a) of IAS 1 requires an entity to present separately, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method.

11. The term ‘effective interest method’ and other related terms are defined in Appendix A of IFRS 9. IFRS 9 also provides the relevant requirements for calculating interest revenue using the effective interest method.

What does IFRS 9 say?

12. Appendix A of IFRS 9 defines the term 'effective interest method' and a number of related terms. All of those interrelated terms pertain to the requirements in that Standard for amortised cost measurement and the expected credit loss impairment model.

13. Specifically, the term 'effective interest method' is defined as follows:

> The method that is used in the calculation of the **amortised cost of a financial asset or a financial liability** and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

14. The term 'amortised cost of a financial asset or financial liability', as it is used in the definition of 'effective interest method', is defined as follows:

> The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance.**

15. Applying those definitions, the effective interest method applies *only* to those financial instruments for which amortised cost is calculated. That is, with regards to financial assets, the effective interest method is a measurement technique whose purpose is to calculate amortised cost and, in doing so, allocate interest revenue over the relevant time period.

16. The expected credit loss impairment model in IFRS 9 is part of, and interlinked with, amortised cost accounting. As described in paragraph 14 of this paper, the amortised cost of a financial asset includes an adjustment for any loss allowance. Also, applying paragraph 5.4.1 of IFRS 9, the calculation of interest revenue using the effective interest method depends on whether the financial asset is credit-impaired.

17. IFRS 9 has three categories for subsequently measuring financial assets: amortised cost, fair value through other comprehensive income (FVOCI) and

FVPL. Amortised cost accounting, including interest revenue calculated using the effective interest method and credit losses calculated using the expected credit loss impairment model, is applied to financial assets in only *two* of those measurement categories: amortised cost and FVOCI.

18. The application of amortised cost accounting to financial assets in the amortised cost measurement category is self-evident and likely does not need further explanation. With regards to financial assets in the FVOCI measurement category, although the financial asset is measured at fair value in the statement of financial position, amortised cost information is presented in profit or loss. Specifically, paragraph B5.7.1A of IFRS 9 says that the FVOCI measurement category recognises information in profit or loss as if the financial asset is measured at amortised cost, and paragraph 5.7.10 of IFRS 9 says that interest revenue calculated using the effective interest method is recognised in profit or loss for financial assets in the FVOCI measurement category. Furthermore, paragraph 5.5.1 says that a loss allowance for expected credit losses is recognised for financial assets in the amortised cost and FVOCI measurement categories.

19. In contrast, amortised cost accounting is not applied to financial assets in the FVPL measurement category. Specific to the instruments described in the submission, paragraph B4.1.9 of IFRS 9 says that derivative financial instruments such as stand-alone option, forward and swap contracts (which would include the 'trading derivatives' described in the submission) cannot be subsequently measured at amortised cost or FVOCI. Instead they must be measured at FVPL. In other words, amortised cost accounting, including interest revenue calculated using the effective interest method and credit losses calculated using the expected credit loss impairment model, is not applied to those financial assets.

20. Consequently, we think the requirement in paragraph 82(a) of IAS 1 to present separately an interest revenue line item calculated using the effective interest method applies *only* to those assets that are subsequently measured at amortised cost and FVOCI.

21. We think our conclusion is consistent with the fact that this presentation requirement was discussed, exposed and ultimately added to IAS 1 by the phase

of the IFRS 9 project that addressed amortised cost measurement and impairment methodology (ie 'Phase 2'). We think it is also consistent with the Board's views on the relevance and usefulness of the information provided by the effective interest method and amortised cost measurement. As described in paragraphs BC4.171 and BC4.172 of the Basis for Conclusions on IFRS 9, the Board's long-standing view has been that the effective interest method, and thus amortised cost, provides relevant and useful information only about particular financial assets (ie assets with 'simple' contractual cash flows that are solely payments of principal and interest) in particular circumstances (ie when collecting those contractual cash flows is integral to achieving the objective of the business model within which the asset is held). The Board has observed that the effective interest method is a relatively simple measurement technique and thus is suitable only for 'simple' contractual cash flows. Only financial assets that meet the conditions to be subsequently measured at amortised cost or FVOCI have such 'simple' contractual cash flows (ie solely principal and interest), and are held within a business model in which collecting contractual cash flows is integral to achieving its objective. Therefore, we think the requirement in paragraph 82(a) of IAS 1 to present separately interest revenue calculated using the effective interest method would result in relevant and useful information about financial assets in these measurement categories.

22. In contrast, as described in paragraphs BC4.23 and BC4.172 of the Basis for Conclusions on IFRS 9, the Board has consistently said that the effective interest method is not an appropriate method for allocating contractual cash flows that are not solely payments of principal and interest; for example, the contractual cash flows that arise from derivatives (which would include the 'trading derivatives' described in the submission). Therefore, consistent with our conclusion in paragraph 20 of this paper, we think the Board would not have intended for these instruments to be within the scope of the requirement in paragraph 82(a) of IAS 1 to present a separate line comprising interest revenue calculated using the effective interest method.

23. As a final note, we observe that the 'interest' described in the submission reflects 'accrued and realised cash flows' on a 'trading derivative' such as an interest rate

swap. Therefore, in addition to the fact that such an instrument is not within the scope of the presentation requirement in paragraph 82(a) of IAS 1 because the instrument must be measured at FVPL, it is not within the scope of that presentation requirement because such 'interest' amounts are not calculated using the effective interest method.

Question 1 for the Committee
1. Does the Committee agree with our analysis that the requirement added to paragraph 82(a) of IAS 1 by IFRS 9 to present separately interest revenue calculated using the effective interest method applies only to those financial assets that are subsequently measured at amortised cost or fair value through other comprehensive income?

Should the Committee add this matter to its standard setting agenda?

24. On the basis of our analysis set out in this paper, we think the principles and requirements in IFRS Standards provide an adequate basis for an entity to apply paragraph 82(a) of IAS 1 and present separately, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method.

Staff recommendation

25. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the IFRS Foundation *Due Process Handbook*, we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that outlines how an entity applies the applicable requirements in paragraph 82(a) of IAS 1.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?   3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A — Proposed wording of the tentative agenda decision

IAS 1 ***Presentation of Financial Statements*** **and IFRS 9** ***Financial Instruments*****— Presentation of interest revenue on particular financial instruments**

The Committee received a request about the effect of the consequential amendment that IFRS 9 made to paragraph 82(a) of IAS 1. That consequential amendment requires an entity to present separately, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method. The submitter asked whether that new requirement affects the presentation of fair value gains and losses on derivative instruments that are not part of a designated and effective hedging relationship (applying the hedge accounting requirements in IFRS 9 or IAS 39 *Financial Instruments: Recognition and Measurement*).

Appendix A of IFRS 9 defines the term 'effective interest method' and a number of other related terms. Those interrelated terms pertain to the requirements in IFRS 9 for amortised cost measurement and the expected credit loss impairment model. The Committee observed that, applying those definitions, the effective interest method applies only to those financial instruments for which amortised cost is calculated. With regards to financial assets, the effective interest method is a measurement technique whose purpose is to calculate amortised cost and, in doing so, allocate interest revenue over the relevant time period. The Committee also observed that the expected credit loss impairment model in IFRS 9 is part of, and interlinked with, amortised cost accounting.

The Committee noted that amortised cost accounting, including interest revenue calculated using the effective interest method and credit losses calculated using the expected credit loss impairment model, is applied only to financial assets that are subsequently measured at amortised cost or fair value through other comprehensive income. In contrast, amortised cost accounting is not applied to financial assets that are subsequently measured at fair value through profit or loss.

Consequently, the Committee concluded that the requirement in paragraph 82(a) of IAS 1 to present separately an interest revenue line item calculated using the

effective interest method applies only to those assets that are subsequently measured at amortised cost and fair value through other comprehensive income. The Committee did not consider any other presentation requirements in IAS 1 or broader matters related to the presentation of other 'interest' amounts in the statement of comprehensive income because the consequential amendment that IFRS 9 made to paragraph 82(a) of IAS 1 did not affect those matters.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to apply paragraph 82(a) of IAS 1 and present separately, in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss, interest revenue calculated using the effective interest method. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B — Submission

B.1. We have reproduced the submission below. We have deleted details that would identify the submitter of this request.

IFRS IC agenda submission: Presentation of interest for trading derivatives under IFRS 9

Background

IFRS 9, Financial Instruments, amends paragraph 82(a) of IAS 1, Presentation of Financial Statements, as follows:

> '*In addition to the items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:*
>
> *(a) revenue, presenting separately interest revenue calculated using the effective interest method;*'… [new words shown underlined]

Derivative instruments that are not part of IFRS 9/IAS 39 designated and effective hedging relationships (hereafter referred to as 'trading derivatives') are measured at fair value though profit or loss. There is no guidance in IFRS on whether to separate fair value gains and losses on trading derivatives into components that are akin to interest and other gains or losses and present them in separate line items in the income statement. However, as discussed below some entities, in particular some banks and other financial institutions, choose to do this under IAS 39 for some or all of their trading derivatives. For example, some entities holding interest rate swaps and currency swaps have a policy of presenting interest on an accruals basis (i.e. the accrued and realised cash flows on the swap) within interest income or interest expense, and presenting other fair value gains and losses within trading gains and losses. This presentation may be applied to all trading derivatives or only some, for example: 'economic hedges' (ie derivatives that the entity uses to manage risk but to which hedge accounting has not been applied); those related to the financing of trading activities; or those used to manage risk on debt instruments that have been designated at fair value through profit or loss.

The issue

The issue is whether the consequential amendment made by IFRS 9 to IAS 1 paragraph 82(a) has the effect that the entities applying IFRS 9 are prohibited from presenting interest on an accruals basis as interest revenue, separately from other movements in fair value.

Please note this submission addresses only trading derivatives, i.e. derivatives that are not part of IFRS 9/IAS 39 designated and effective hedging relationships, but we use the term trading derivatives to include 'economic hedges'.

Alternative views

View A: Yes, an entity is prohibited from presenting interest on an accruals basis on trading derivatives as interest revenue in accordance with IAS 1 (revised)

This view interprets paragraph 82(a) of IAS 1 as meaning that only interest calculated using the effective interest method in accordance with IFRS 9 can be included as interest in the income statement.

The 'interest' component of a trading derivative that some entities include in interest income under IAS 39 is not calculated using the effective interest method as defined in IFRS 9. This is because it applies the effective interest method to the notional amounts of a derivative, instead of the derivative's carrying amount on an amortised cost basis. Hence it cannot be presented as interest revenue in accordance with IAS 1 paragraph 82(a) (as revised by IFRS 9).

Appendix A of IFRS 9 defines the effective interest method as '*the method that is used in the calculation of amortised cost of a financial asset or financial liability and in the allocation and recognition of interest revenue or interest expense in profit or loss over the relevant period*'.

A trading derivative is one unit of account, with no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. Applying the effective interest method in accordance with IFRS 9 would require determining a single effective interest rate at inception that is not relevant in the context of a derivative such as

an interest rate swap that has both a fixed and a floating rate leg. Furthermore, in subsequent periods, the application of IFRS 9 paragraph B5.4.6 (that is required when the effective interest method is applied) would result in frequent and potentially large adjustments to interest revenue that would not be relevant to an understanding of the financial statements. The effect would be very different from today's practice of presenting the accrued and realised cash flows on the swap within interest income or interest expense.

Furthermore it is not appropriate to present interest on trading derivatives that are viewed as 'economic hedges' in the same way as derivatives that are accounted for as designated and effective hedges in accordance with IFRS 9. IFRS has no notion of an economic hedge and hedge accounting should be applied only when the necessary requirements in IFRS 9 have been complied with.

Those who support view A agree that additional line items and subtotals are presented by an entity in accordance with IAS 1 para 85 when such presentation is relevant to an understanding of the entity's financial performance. However, any such line items are required to be 'made up of items recognised and measured in accordance with IFRS' (IAS 1 para 85A(a)). This prohibits an additional line item within net interest income for 'interest' calculated as the accrued and realised cash flows on a swap.

View B: No, an entity is not prohibited from presenting interest on trading derivatives as interest revenue when the effective interest method is applied by viewing the derivative as comprising two debt instruments

This view takes a wider interpretation of what is meant by 'calculated using the effective interest method' in the context of paragraph 82(a) of IAS 1 (as revised by IFRS 9).

A derivative, for example a plain vanilla interest rate swap, can be deconstructed into two 'legs' and viewed as a pair of loans, generally a fixed-rate loan and a floating rate loan; both with the same principal value. On one of the loans, the 'payable leg', interest is paid by the entity; on the other loan, the 'receivable leg', interest is received by the entity. Interest using the effective interest method can be calculated on each leg which can then be presented within interest revenue/expense. Any adjustment of the carrying amount due to changes in estimated cash flows in accordance with IFRS 9 paragraphs B5.4.5 and B5.4.6 would also be presented within interest revenue/expense.

Presenting interest separately from other fair value gains and losses is consistent with paragraphs B5 and BC34 of IFRS 7:

> *B5 For financial instruments, such disclosure [of accounting policies used] may include:*
>
> *(e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20 (a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.*
>
> *BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities held for trading and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities held for trading include interest and dividend income (see Appendix B, paragraph B5(e)).*

This presentation can result in more relevant information, particularly for economic hedges in accordance with the entity's risk management strategy.

View C: No, an entity is not prohibited from presenting interest on trading derivatives as a separate line item within interest revenue using any reasonable method

IFRS 7 paragraphs B5 and BC34 indicate that an entity may present interest on financial assets and financial liabilities held for trading (which includes derivatives) separately from other gains and losses.

Furthermore, additional line items and subtotals shall be presented by an entity in accordance with IAS 1 paragraph 85 when such presentation is relevant to an understanding of the entity's financial performance. As noted under view A, IAS 1 requires that any such line items are 'made up of items recognised and measured in accordance with IFRS' (IAS 1 para 85A(a)). However, those who support view C think the changes in fair value of a swap can be decomposed into 'interest' calculated as the accrued and realised cash flows on the swap and other changes in fair value, provided

each component is appropriately presented and labelled in accordance with IAS 1 paragraph 85A(b).

Hence an entity can include interest on trading derivatives as a separate line item within interest revenue/expense using any reasonable method that results in more relevant information. This would include presenting the accrued and realised cash flows on a swap as interest but could also include other methods. Such a presentation can result in more relevant information, particularly for economic hedges in accordance with the entity's risk management strategy.

Current practice

Under IAS 39, there is significant diversity in treatment with some banks not reporting interest separately on any items measured at fair value through profit or loss, others presenting interest separately for some such items (eg derivatives that are economic hedges) and others extending the separate presentation of interest to cover all trading derivatives.

This diversity was also noted by the European Securities and Markets Authority (ESMA) in its report 'Review of Accounting Practices – Comparability of EU-IFRS Financial Statements of Financial Institutions in Europe' published in November 2013 (ref ESMA/2013/1664). ESMA's study of accounting practices in Europe was based on the 2012 IFRS consolidated financial statements of 39 large European financial institutions from 16 jurisdictions. Paragraph 31 of ESMA's report states:

> *(31) The policy of including interest income/expense on derivative financial instruments was diverse. Based on ESMA's observations, the presentation of the interest component of derivatives that do not qualify for hedge accounting (alternatively only for instruments labelled as 'economic hedges' or 'banking book derivatives') was fairly mixed between interest income/expense and net trading income. For some financial institutions, however, it was not possible to determine where interest income/expense on non-hedging derivatives was recognised.*

Whilst the report quoted above studied only banks in Europe, we understand similar diversity exists in many other parts of the world.

Reasons for the Interpretations Committee to address the issue

Below we consider the Interpretations Committee's agenda criteria.

In our experience the diversity in practice is widespread across many different territories. Net interest is typically included in key performance indicators for financial institutions and therefore the impact of a change in presentation is expected to be material to those entities concerned, even though the presentation does not impact total profit or loss.

Comparability and consistency of financial reporting would be improved by eliminating different presentation methods.

The issue involves clarifying the meaning of 'interest revenue calculated using the effective interest method' in IAS 1 paragraph 82(a). It is therefore is narrow in scope and can be resolved efficiently within the confines of IFRS standards and the Conceptual Framework for Financial Reporting. As the amendment to IAS 1 paragraph 82(a) is introduced by IFRS 9, any solution would have longevity.

Timescale

The consequential amendment to IAS 1 applies when IFRS 9 is adopted (ie for accounting periods beginning on or after 1 January 2018). We therefore request that the Interpretations Committee expedites this issue, so that entities have timely guidance as they first apply the new requirements.