IFRS

STAFF PAPER

July 2021

IASB® meeting

Project	**Primary Financial Statements**
Paper topic	Classification of fair value gains or losses on derivatives and hedging instruments

CONTACT(S)	Iliriana Feka	ifeka@ifrs.org
	Aida Vatrenjak	avatrenjak@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

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 fair value gains or losses on:

   (a) derivative and non-derivative instruments designated in a hedging relationship to which hedge accounting is applied in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* (hedging instruments);

   (b) derivatives used for risk management to which hedge accounting is not applied, either because the entity has chosen not to, or the qualifying criteria are not met (non-designated derivatives); and

   (c) derivatives not used for risk management purposes.

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 gains or losses on derivatives and hedging instruments, with additional detail.

Summary of staff recommendations

3. We recommend the Board makes the following changes to its proposals in paragraphs 57–59 of the Exposure Draft:

   (a) replaces the investing category, as the default category, with the operating category; and

   (b) requires entities to classify gains or losses on derivatives related to financing activities, not used in the course of the entity's main business activities, in the financing category.

4. This means, to require an entity to classify gains or losses:

   (a) on hedging instruments, in the category of statement of profit or loss affected by the risk the entity manages, except when doing so would involve grossing up gains or losses. In this case, an entity would classify all gains or losses on the derivative in the operating category.

   (b) applying the requirements of paragraph 4(a) to derivatives used for risk management even if those derivatives are not designated as hedging instruments applying IFRS 9 or IAS 39, except when doing so would involve undue cost or effort. In this case, an entity would classify all gains or losses on the derivative in the operating category.

   (c) on derivatives not used for risk management in the operating category, unless a derivative relates to financing activities and is not used in the course of the entity's main business activities. In this case, an entity would classify all gains or losses on the derivative in the financing category.

5. In addition, as explained more fully in paragraphs 54–58 we have identified some drafting suggestions that we will consider when preparing the final amendments (if the Board decides to proceed).

Structure of the paper

6. This paper is structured as follows:
   (a) proposals in the Exposure Draft;
   (b) feedback;
   (c) staff analysis; and
   (d) staff recommendations and question for the Board.

7. The paper includes the following appendices:
   (a) Appendix A—Analysis of other comments
   (b) Appendix B—Fieldwork findings

Proposals in the Exposure Draft

8. The Board's proposals for the classification of gains or losses on derivatives and hedging instruments can be summarised as follows (paragraphs 57–59 of the Exposure Draft[1]):

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="2">Gains or losses on:</th></tr>
<tr><th>Derivatives</th><th>Non-derivative financial instruments</th></tr>
<tr><td rowspan="2">Used for risk management</td><td>Hedging instruments</td><td colspan="2">Classify in the category affected by the risk the entity manages, except when it would involve grossing up gains or losses—then classify in the investing category.</td></tr>
<tr><td>Not designated in hedging relationships</td><td>Apply the classification requirements for hedging instruments except if such classification would involve undue cost or effort—then classify in the investing category.</td><td>Apply requirements for classification in paragraphs 45–55 of the Exposure Draft.</td></tr>
<tr><td colspan="2">Not used for risk management</td><td>Classify in the investing category, except when used in the course of a main business activity—then classify in the operating category.</td><td>Not relevant for this paper</td></tr>
</table>

9. Paragraphs B41 and B42 of the Exposure Draft explain the prohibition of grossing up of gains or losses on hedging instruments and non-designated derivatives used for risk management. In the Board's view, grossing up of gains or losses might result when an

[1] See also paragraphs B40–B43 and BC93–BC102 of the Exposure Draft for additional information on the proposals.

entity uses such financial instruments for risk management of a group of items with offsetting risk positions (see paragraph 6.6.1 of IFRS 9 for hedging instruments) and the risks managed affect line items in multiple categories of the statement of profit or loss.

10. For example, an entity may use a single derivative to manage the net foreign currency risk on revenue (classified in the operating category) and interest expenses (classified in the financing category). In such cases, the foreign exchange differences on the revenue are offset by the foreign exchange differences on the interest expense and the gains or losses on the derivative. However, the foreign exchange differences on the revenue are classified in a different category of the statement of profit or loss to the foreign exchange differences on the interest expense. To present the net foreign exchange difference in each category, an entity would need to present in each category a larger gain or loss than occurred on the derivative. Applying the requirements in paragraphs 57–58 of the Exposure Draft, an entity shall not gross up the gains or losses in this manner and would instead classify any gain or loss on the derivative in the investing category.

Feedback

11. Some respondents did not comment on these proposals and a few commented but did not express a view. Of those who commented:

    (a) a few explicitly agreed with the Board's proposals saying it would appropriately reflect an entity's activities. These respondents also welcomed the fact that the Board addressed classification of gains or losses on non-designated derivatives, noting that there is diversity in practice on this area.

    (b) many other respondents:

        (i) disagreed with the use of the investing category as the default category (paragraphs 12–14);

        (ii) asked how to apply the proposals to the gains or losses on derivatives related to financing activities (paragraph 15); or

        (iii) expressed concerns with the classification of gains or losses on non-designated derivatives used for risk management (paragraphs 16–18).

Use of investing as the default category

12. Some respondents disagreed with the Board's proposals to use investing category as the default category for classification of gains or losses on derivatives and hedging instruments. In their view, the classification in the investing category, in particular for hedging instruments and non-designated derivatives used for risk management, would be arbitrary and would not provide faithful representation of the risks the entity is managing with these financial instruments. Specifically, they disagreed with the use of the investing category:

    (a) **when it would involve grossing up of gains or losses**—respondents said that the Board's reason for classification in the investing category in these cases is unclear. These respondents noted classification in the investing category, would result in accounting mismatches between categories, not provide a faithful representation of entities' risk management and be difficult to explain to users of financial statements.

    (b) **when the undue cost or effort exemption is met**—respondents disagreed with the proposal to classify gains or losses on non-designated derivatives used for risk management in the investing category when the undue cost or effort exemption is met. They said the outcome of this proposal could lead entities to present an investing category for no reason other than to classify such gains or losses. Also, they said it would not faithfully represent the entity's risk management, when the entity is managing risks unrelated to the income and expenses from the investing category.

    (c) **for gains or losses on derivatives not used for risk management**—only a few respondents commented on this area. They expressed disagreement with the use of the investing category because they do not consider derivatives as investments. See also feedback in paragraph 15.

13. Some respondents suggested the Board considers other categories as the default category for derivatives and hedging instruments. For example, the operating category was considered more appropriate in some circumstances.

14. Only one comment letter was received from users of financial statements. For reasons similar to those described in paragraph 12, the representative body of users of

financial statements expressed concerns with the Board's proposal for use of the investing as the default category.

Derivatives related to financing activities

15. A few respondents asked how to apply the Board's proposals to gains or losses on derivatives related to financing activities that are not used for risk management, such as an embedded derivative separated from the host contract applying IFRS 9. For example, a written call option that allows the holder to exchange a fixed amount of a foreign currency for a fixed number of entity's own shares. If the option issued does not meet the fixed-for-fixed condition in IAS 32 *Financial Instruments: Presentation*, the option would be classified as a derivative financial liability in the statement of financial position.[2] They asked the Board to clarify the application of proposals to gains or losses on these financial instruments. Specifically, they asked whether entities are required to apply the proposal in paragraph 59 of the Exposure Draft in which case the classification outcome would be the investing category. These respondents are of the view that these derivatives are related to entity's financing activities and thus the gains or losses should be classified in the financing category.

Classification of gains or losses on non-designated derivatives used for risk management

16. In addition to paragraphs 12(a)–12(b), respondents expressed additional concerns relating to the proposal in paragraph 58 of the Exposure Draft about classification of gains or losses on non-designated derivatives used for risk management.

17. Some disagreed with the proposal to classify the gains or losses in the category affected by the risk the entity manages, saying that would require additional financial reporting processes and controls, including increased auditing costs. This included a few respondents who suggested the Board should instead require classification of gains or losses on all derivatives, other than hedging instruments, in a *single category*. In their view, this would enhance consistent application of the proposals. We did not

[2] Fixed-for-fixed condition refers to the requirements in paragraph 16(b)(ii) of IAS 32.

consider this approach because as noted in paragraph BC96 of the Exposure Draft, classifying gains or losses on derivatives in a manner that faithfully represents the risk the entity is managing with that instrument, instead of classifying them in a single category, would provide a more faithful representation of an entity's activities.

18. In addition, a few respondents (including a few auditors and regulators) were concerned that without the discipline of hedge accounting requirements in IFRS 9 or IAS 39, and in absence of any application guidance, applying this proposal could lead to diversity in practice and may risk unintended consequences. To address these concerns, they suggested the Board should at least specify:

    (a) the meaning of derivatives 'used for risk management'.

    (b) what requirements apply for risk management documentation? They asked if the Board meant for entities applying this proposal to apply the risk management documentation requirements in IFRS 9.

    (c) whether the purpose of the derivatives should be monitored and when is a classification change justified?

    (d) whether entities are permitted to disaggregate the fair value gains or losses on non-designated derivatives into components and classify them separately to reflect entity's risk management and its success? Overall, these respondents were concerned that unless the Board specifies otherwise, entities may disaggregate fair value gains or losses for non-designated derivatives. Consequently, entities may present 'hedge accounting-like' results without being subject to the robust hedge accounting requirements.

Other comments

19. Entities in the financial industry said that applying the proposals, they expect to classify most gains or losses on derivatives and on hedging instruments in the operating category and were not generally concerned by these proposals.

20. Except as analysed in the Agenda Paper 21C for this Board meeting, no other feedback was received in relation to the Board's proposal for classification of non-derivatives used for risk management not designated in hedging relationships.[3]

21. A few respondents asked specific application questions about the proposals. We have summarised those comments and related staff analysis in Appendix A to this paper. By comparison to the feedback described so far, the comments in Appendix A represent a mixture of different suggestions, clarifying or editorial in nature. Based on our analysis of those comments, we recommend no changes to the proposals.

Staff analysis

22. This staff analysis is structured as follows:

    (a) the Board's objective (paragraphs 23–24);

    (b) whether the Board needs to change the proposals in the Exposure Draft? (paragraph 25);

    (c) classification of gains or losses on hedging instruments and non-designated derivatives used for risk management (paragraphs 26–37);

    (d) classification of gains or losses on derivatives not used for risk management (paragraphs 38–52); and

    (e) application guidance on non-designated derivatives used for risk management (paragraphs 53–58).

[3] In providing feedback about classification of foreign exchange differences, a few respondents suggested the proposal should reflect 'natural' risk management ie align classification categories for exchange differences arising on translation of items that are managed together. This would mean the classification outcome should reflect the effect of non-derivative financial instruments used for risk management not designated in hedging relationships. As explained in the agenda paper 21C for this Board meeting, we disagree with such approach for the reasons noted in paragraph BC102 of the Exposure Draft.

The Board's objective

23. The Board's objective for proposals on classification of gains or losses on derivatives and on hedging instruments was to:

    (a) achieve classification outcomes that result in the proposed defined subtotals providing a faithful representation of an entity's activities. It was noted that this generally means classifying gains or losses on derivatives and hedging instruments in a manner that reflects the risk managed with a hedging instrument or non-designated derivative used for risk management.

    (b) enhance comparability of the Board's defined subtotals between different entities.

24. We continue to agree with this objective and think that most feedback does not suggest a change to the objective. Hence, consistent with this objective, classification of gains or losses on hedging instruments and non-designated derivatives used for risk management should faithfully represent the risk the entity manages with such financial instruments. In our view, feedback in paragraph 15 suggests that, in order to achieve classification outcomes that result in the proposed defined subtotals providing a faithful representation of an entity's activities, classification should also reflect the purpose for which the entity is holding the derivatives related to financing activities not used for risk management. We suggest expanding the objective to reflect this.

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

25. In our view, feedback from respondents suggests the Board should redeliberate its proposals, to consider whether:

    (a) the use of the investing category as the default category remains appropriate. This is relevant for classification of gains or losses on hedging instruments, non-designated derivatives used for risk management, and derivatives not used for risk management;

    (b) it could address feedback on derivatives related to financing activities in a pragmatic way; and

(c) it could provide additional application guidance to help achieve consistent application for classification of gains or losses on non-designated derivatives used for risk management.

Hedging instruments and non-designated derivatives used for risk management

26. The use of the investing category as the default category is the primary issue raised by respondents with respect to classification approach for hedging instruments and non-designated derivatives used for risk management (see paragraphs 12(a)–12(b)). Specifically, they disagreed with using the investing category:

    (a) for hedging instruments and non-designated derivatives used for risk management—when it would involve grossing up of gains or losses; and

    (b) for non-designated derivatives used for risk management—when undue cost or effort exemption is met.

27. In paragraph BC93 of the Exposure Draft, the Board noted its rationale for using the investing category as the default category—that is, derivatives generally generate returns individually and largely independently of the entity's other resources. Consequently, gains or losses on a derivative arguably most closely align with the definition of income and expenses from investments.

28. However, in its discussions leading to the proposal for use of the investing category in these cases, the Board was mindful that it may not be clear whether derivatives are 'assets that generate a return', because derivatives may not require any initial net investment, thus different views may exist amongst stakeholders.

When it would involve grossing up gains or losses

29. We are sympathetic to respondents' concerns described in paragraph 12(a). Classification of gains or losses on hedging instruments and on non-designated derivatives used for risk management *in the investing category* in the cases when it would involve grossing up of gains or losses may lead to outcomes that do not reflect risk management, create mismatches and thus do not provide useful information. For example, an entity may use a hedging instrument to manage a group of items that have offsetting risks positions affecting items in the operating category and items in

the financing category. In these cases, classification in the investing category does not reflect the risks managed and gives rise to mismatches between categories. This is consistent with the concern raised by users of financial statements (see paragraph 14).

30. In our view, the reason the Board specified using the investing category in the Exposure Draft for these cases is because it may not be clear to entities what category to use when an entity hedges a group of items with offsetting risk positions that affect multiple categories in the statement of profit or loss. In other words, specifying that in these cases entities use the investing category aims to help with the consistent application of proposals. The Board's rationale for using the investing category (rather than the operating or financing category) is described in paragraph 27.

31. Paragraphs 6.6.4 and B6.6.15–B6.6.16 of IFRS 9 (applicable to hedging instruments) set out the presentation requirements for a designated hedge of a group of items with offsetting risk positions (ie a hedge of a net position) whose hedged risk affects different line items. They require gains or losses on the hedging instrument to be presented in a *separate line item*, rather than being included in the line items affected by the hedged items. This is so that in the statement of profit or loss and other comprehensive income, the amount in the line item that relates to the hedged item itself (for example, interest revenue or expenses) remains unaffected. Paragraphs BC6.456–BC6.461 of the Basis for Conclusions on IFRS 9 explain that the Board's rationale for this requirement was to avoid entities grossing up gains or losses from a single hedging instrument in such cases.

32. Considering the requirements described in paragraph 31, some respondents said classification in the investing category is not necessary in order to avoid grossing up. Entities can achieve that by presenting gains or losses on derivatives in a separate line item to the categories affected by the hedged items. We agree with this observation. However, we think the Board still needs to specify a category so that entities are clear what category to use for hedges of a group of items with offsetting risk positions that affect multiple categories.

33. In light of the concerns identified by respondents (see paragraph 12(a)) and our observations in paragraphs 29–32, we think the Board should change its proposal so that if classification would involve grossing up of gains or losses, the entity classifies gains or losses on the hedging instruments and non-designated derivatives used for

risk management in the operating (instead of the investing) category. We think this change would:

(a) better reflect risk management and reduce mismatches—this is true for cases when the entity uses these hedging instruments and non-designated derivatives used for risk management of a group of items with offsetting risk positions that include items in the operating category. For many entities, the hedges involving operating items would be more pervasive.

(b) enhance usefulness of information to users of financial statements—entities would not need to provide additional information to users of financial statements to explain the rationale for reporting gains or losses in the investing category, when entity has no hedges related to investments.

(c) be consistent with the Board's definition of the operating category—in this case, the operating category is used as a residual category ie only for these special cases when it would involve grossing up of gains or losses. Hence it is consistent with the Board's definition of the operating category as the residual or the default category for classification of income and expenses in the statement of profit or loss.

When undue cost or effort exemption is met for non-designated derivatives used for risk management

34. We considered respondents' concerns in paragraph 12(b) about the use of the investing category as the default category, when allocating gains or losses in the categories affected based on the risk managed involves undue cost or effort. Respondents described cases when the entity knows the derivative is used for risk management (eg when the entity is prohibited from holding derivatives for a purpose other than risk management by its internal policies), but the cost or effort to allocate the gains or losses in the categories affected meets the undue cost or effort exemption.

35. For example, if an entity's central Treasury function is the counterparty to internal derivatives used for risk management which are then externalized on a net exposure basis. In this case, the allocation of gains or losses on the external derivative(s) into the affected categories in the statement of profit or loss may involve undue cost or effort. Nevertheless, the external derivative is in fact used for risk management. If,

for example, this entity has no risk exposures arising from the investing category, the classification in the investing category which applying the proposal is the default category would be misleading.

36. We acknowledge that in this example, the Board’s objective for achieving faithful representation of the risk that the entity manages (see paragraphs 23–24) is not met because classification in the investing category fails to depict the fact these derivatives are used for entity’s risk management.

37. The Board could address these concerns by changing the default category to the operating (instead of the investing) category. We think this change is justified for reasons similar to those described in paragraph 33. For example, it would better reflect risk management of derivatives, in particular, in cases when the entity does not have, or manage, any risk exposures arising from items in the investing category. In addition, it may reduce mismatches, in particular in cases when the entity manages risk exposures arising from items in the operating category.

Derivatives not used for risk management

38. Applying paragraph 59 of the Exposure Draft, gains or losses on derivatives not used for risk management would be classified in the investing category except when those derivatives are used in the course of the entity’s main business activities, in which case they are classified in the operating category.

39. Two issues were identified from respondents with regards to classification of gains or losses on derivatives not used for risk management, namely classification of gains or losses on:

    (a) derivatives related to financing activities (see analysis in paragraphs 40–48); and

    (b) other derivatives not used for risk management (see analysis in paragraphs 49–52).

Derivatives related to financing activities

40. We first considered the feedback described in paragraph 15 about classification of derivatives related to financing activities not used for risk management. For example,

derivatives that involve an exchange of entity's own equity instruments with another financial instrument. The financial instruments we are discussing here are classified as derivatives because they do not meet the requirements in IAS 32 to be classified as equity. The respondents who raised this issue are of the view that these instruments are in substance financing arrangements and as such the gains or losses should be classified in the financing category, not in the investing category.

41. We are sympathetic to respondents' concerns. The classification outcome in the investing category does not faithfully represent the purpose of these derivatives. Some examples considered include:

<table>
<tr><th>Derivative financial instrument</th><th>Potential classification outcome
applying paragraph 59 of the Exposure Draft</th></tr>
<tr><td>Conversion option embedded in a foreign currency convertible bond—once separated from the host, the conversion option represents a written call option that converts a fixed principal amount of the foreign currency bond into a fixed number of the entity's equity instruments at the option of the bondholder.</td><td rowspan="2">An entity may be using the conversion option as part of its financing activities (eg as part of raising finance in a cost-effective manner). Therefore, in this example, the derivative is not used for risk management.

Applying the proposal in paragraph 59 of the Exposure Draft, the gains or losses on this derivative would be classified in the <u>investing category</u> except when those derivatives are used in the course of the entity's main business activities, in which case they are classified in the <u>operating category</u>.</td></tr>
<tr><td>Foreign currency call option as a standalone derivative—a purchased call option that allows the issuing entity to exchange a fixed amount of a foreign currency for a fixed number of entity's equity instruments.</td></tr>
</table>

42. A respondent suggested the Board requires an entity to classify the gains or losses on embedded derivatives in the same category as income and expenses on the host contract. This respondent is of the view that the classification outcome should be the financing category for the items in profit or loss from the host contract and items from the embedded derivative separated from the host. We have concerns about this approach for the reasons in paragraph 44.

43. Paragraph 4.3.3 of IFRS 9 states:

> 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;
>
> (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 FVPL (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

44. Paragraph 4.3.3(a) of IFRS 9 requires an embedded derivative to be separated from the host[4] when the risks inherent in the host and the embedded derivative are dissimilar. Therefore, in our view, it would be counterintuitive for the Board to require an entity to align classification of income and expenses on the host contract with that of the embedded derivatives separated from host. In other words, if the risks inherent in the host and the embedded derivative are not closely related (ie dissimilar), we question why the classification should be the same in all cases. In addition, the suggested approach would not address the classification of derivatives that do not arise from the embedded derivatives (ie derivatives purchased on a standalone basis) because in those cases there is no host contract.

45. As illustrated in paragraph 41, applying the proposals to these derivatives relating to financing activities that are not used for risk management, an entity would classify gains or losses on the derivative in the investing category (unless used in the course of the entity's main business activities, in which case they are classified in the operating category). We do not think that this classification outcome faithfully represents the purpose of these derivatives, and neither their effects on the entity's activities.

[4] Subject to also meeting the other requirements in paragraph 4.3.3 of IFRS 9.

46. We agree with respondents' view that for these types of derivative instruments classification in the financing category of the statement of profit or loss would provide useful information. Often these derivatives are transacted as part of raising finance in a more cost-effective manner, therefore, the financing category would better depict their effect on the entity's activities. That would also be consistent with the discussion on the Board's objective in paragraph 24.

47. Therefore, we recommend the Board amends its proposal in paragraph 59 of the Exposure Draft to require entities to classify gains or losses on the *derivatives related to financing activities* in the financing category of the statement of profit or loss.

48. We describe the population of these derivatives as 'derivatives relating to financing activities' to explain their financing characteristics. However, this description does not necessarily reflect how it will eventually be drafted in IFRS Standards. The staff will further explore how to define the population of these derivatives and consequently may further refine this description to be consistent with the terminology used in other IFRS Standards, or to avoid risking unintended consequences.

Other derivatives not used for risk management

49. As noted in paragraph 12(c) some respondents disagree with the Board's rationale for using the investing category as the default category for derivatives not used for risk management. These respondents do not regard derivatives as investments. They also point out that the Board's definition of 'income and expenses from investments' refers only to assets, whereas derivatives could be assets or liabilities ie subsequent to initial recognition, the value of the derivative may be an asset or a liability.

50. The staff note that some non-financial entities are prohibited from holding derivatives for trading purposes by their internal policies. Hence, the residual population of derivatives not used for risk management for which gains or losses would be classified in the investing category may not be significant. This is because gains or losses on derivatives not used for risk management:

    (a) related to financing activities would be classified in the financing category (staff recommendation in paragraph 47); and

(b) used in the course of the entity's main business activities would be classified in the operating category applying the proposal.

51. On this basis, the simplest solution may be to change the proposal to require all gains or losses on derivatives not used for risk management be classified in the financing category ie regardless whether they are related to financing activities or not. This would mean the Board would not have to specify the population of derivatives related to financing activities, see discussion in paragraph 48. However, the disadvantages of such an approach would be:

(a) if the entity has derivatives not used for risk management that are not related to financing activities, classification in the financing category would not faithfully represent their purpose and the effect on entity's activities. While the anecdotal feedback suggests these are rare, we do not have sufficient evidence to assert we do not expect these to be material.

(b) there would still be some derivatives not used for risk management classified outside the financing category. This is because the Board would need to keep the exception in paragraph 59 of the Exposure Draft for gains or losses on derivatives not used for risk management that are *used in the course of the entity's main business activities* to be classified in the operating category.

(c) it would be different to the default category for hedging instruments and non-designated derivatives used for risk management, recommended by the staff to be the operating category (paragraphs 33 and 37). We think using the same default category for other derivatives not used for risk management would reduce complexity and help with consistent application of the proposals.

52. Based on this analysis, we conclude that while classification of all derivatives not used for risk management in the financing category would simplify one aspect of the proposals, it carries the risks of not achieving faithful representation and brings complexity to other aspects of the proposal. On balance, we therefore recommend the Board requires entities to classify in the operating category the gains or losses on other derivatives not used for risk management. Those are gains or losses on derivatives not used for risk management, other than derivatives related to financing activities.

Application guidance on non-designated derivatives used for risk management

53. We considered feedback described in paragraph 18 suggesting the Board provides application guidance on non-designated derivatives used for risk management. Developing comprehensive application guidance about classification of income and expenses in the statement of profit or loss would be beyond the objective of this project. However, we think the Board could provide clarifications to address concerns described in paragraph 18 along the lines of the comments in paragraphs 54–58.

The meaning of derivatives 'used for risk management'

54. In terms of the meaning of derivatives 'used for risk management', we think the Board did not mean to create new terminology or requirements. Whether an entity uses a derivative for risk management or not is a matter of fact (not merely of assertion or documentation). However, in light of the feedback, the Board may consider explaining that it refers to 'the derivatives used in executing the entity's risk management strategy'. Normally, entity's risk management strategy would be approved by key management personnel as defined in IAS 24 *Related Party Disclosures*. Derivatives used for risk management may be derivatives designated in a hedging relationship applying IFRS 9 or IAS 39, or non-designated derivatives used for risk management.

Risk management documentation

55. In response to the feedback about what risk management documentation is required, we do *not* think that the Board intended for entities applying this proposal to apply the risk management documentation requirements in IFRS 9 for hedging instruments. The Board did not specify risk management documentation requirements for non-designated derivatives because applying this proposal only involves considering the link between the risk being managed with that particular derivative and the category in statement of profit or loss affected by that risk management. For example, an entity would consider whether an interest rate swap is used to manage interest rate risk on a liability which affects the financing category (because the interest expense on that liability is classified in the financing category). If so, the entity would classify gains or losses on that interest rate swap in the financing category.

56. We expect this information to be readily available because entities normally only enter into derivatives in accordance with internally approved risk management policies. Risk managers continuously monitor and report internally whether derivatives continue to manage the risks they intended to mitigate. Accordingly, we would expect entities to use reasonable and supportable information that is already available to determine the link to the category affected by the risk managed with a particular derivative.

Change in classification

57. In response to the question when an entity can change the category used for classification of gains or losses on a derivative, we think that assessment is no different to other income and expense in the statement of profit or loss. A classification change is considered when the facts and circumstances have changed. In the context of non-designated derivatives used for risk management, we would expect that normally a change in the risk the entity manages using a derivative would trigger an assessment to determine whether a change in category used to classify gains or losses is required. In other words, at that point, an entity would need to assess what category faithfully represents the new risk that the entity is managing with that derivative and determine whether a change in category is required or not.

Disaggregation of gains or losses

58. Responding to the feedback in paragraph 18(d) about disaggregating fair value gains or losses on a single derivative into components and classifying them separately to reflect entity's risk management and its success—we think such outcome is not consistent with the proposal in paragraph 58 of the Exposure Draft. The Board's objective for this proposal is to help entities achieve appropriate classification in the categories of the statement of profit or loss. The objective is not to reflect the *extent* to which entity's risk management has been achieved. In paragraph BC99 of the Exposure Draft, the Board noted that the recognition and measurement requirements for derivatives, including the hedge accounting requirements, are unchanged by these proposals. We therefore question how entities could consistently achieve faithful representation of the extent to which the entity's risk management strategy was achieved for derivatives to which hedge accounting requirements in IFRS 9 or IAS 39

are not applied. This is because, unlike hedging instruments, these derivatives are not subject to requirements such as the effectiveness assessment required in IFRS 9 or IAS 39.

Staff recommendations and question for the Board

59. Considering the overall feedback, and our analysis so far, we recommend the Board makes the following changes to its proposals:

    (a) replaces the investing category, as the default category, with the operating category; and

    (b) requires entities to classify gains or losses on derivatives related to financing activities, not used in the course of the entity's main business activities, in the financing category.

60. Apart from these changes, we are recommending retaining the Board's proposals for derivatives and hedging instruments because the classification outcomes applying the proposals contribute to faithful representation of the risks the entity manages using these financial instruments, and of the purpose of the derivatives related to financing activities. Therefore, it meets the Board's objectives described in paragraphs 23–24. The Board's reasons for the proposals noted in paragraphs BC96–BC102 of the Exposure Draft remain applicable.

61. As noted in paragraph 20, we do not recommend changes to the Board's proposals for classification of gains or losses on non-derivatives used for risk management that are not designated in hedging relationships.

62. We acknowledge that the classification approach on derivatives and hedging instruments may appear complex. However, each group of derivatives addressed separately in this approach have their own characteristics and purposes, thus tailoring the classification approach to achieve outcomes that contribute to a faithful and complete depiction of those characteristics, in our view, is justified. As discussed in paragraphs 51–52, we considered a simpler approach but concluded it could risk unintended consequences, ie classification that would not achieve faithful representation of entity's activities.

63. The following table summarises the recommendations in this paper, in comparison to the proposals in the Exposure Draft (see paragraph 8).

		Gains or losses on: Underlined text is a change from proposals in the Exposure Draft	
		Derivatives	**Non-derivative financial instruments**
Used for risk management	**Hedging instruments**	Classify in the category affected by the risk the entity manages, except when it would involve grossing up gains or losses—then classify in the *operating* category	
	Not designated in hedging relationship	Classify as above except if such classification involves undue cost or effort—then classify in the *operating* category	Apply requirements for classification in paragraphs 45–55 of the Exposure Draft.
Not used for risk management		Classify in the operating category, unless the derivative relates to financing activities and is not used in the course of the entity's main business activities. In this case, classify in the financing category.	Not applicable to this paper

Question for the Board

Does the Board agree with the staff recommendation to require an entity to classify gains or losses:

(a) on financial instruments designated as hedging instruments in accordance with IFRS 9 or IAS 39, in the category of statement of profit or loss affected by the risk the entity manages, except when it would involve grossing up gains or losses. In this case, an entity would classify all gains or losses on the derivative in the operating category?

(b) applying the requirements described in (a) above to derivatives used for risk management if those derivatives are not designated as hedging instruments in accordance with IFRS 9 or IAS 39 except when doing so would involve undue cost or effort. In this case, an entity would classify all gains or losses on the derivative in the operating category?

(c) on derivatives not used for risk management in the operating category, unless the derivative relates to financing activities and is not used in the course of the entity's main business activities. In this case, an entity would classify all gains or losses on the derivative in the financing category.

Appendix A—Analysis of other comments

A1. This table summarises other comments on classification of gains or losses on derivatives and hedging instruments, together with our analysis and conclusions.

Feedback	Staff analysis	Recommendations
Classification of hedging ineffectiveness (paragraph 57 of the Exposure Draft)		
Some respondents asked the Board to clarify whether applying paragraph 57 of the Exposure Draft would result with a split of hedge ineffectiveness in categories of the statement of profit or loss based in the underlying risk being managed by hedging instruments. In addition, a respondent asked whether the classification outcome of applying the proposal is that *all* gains or losses on *one* hedging instrument will be classified in the same category of statement of profit or loss, eg both (a) amount reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment; and (b) hedge ineffectiveness recognised in profit or loss.	We note that paragraph 57 of the Exposure Draft refers to classification of gains or losses on instruments designated as hedging instruments applying IFRS 9 or IAS 39. The proposal makes no distinction between effective and ineffective portions. Therefore, applying the proposal may result in total hedge ineffectiveness for the period from different hedging instruments be allocated to different categories of the statement of profit or loss. The allocation would be made based on the category affected by the underlying risk managed by the hedging instrument. In our view, classification of hedge ineffectiveness in different categories (when relevant) does not reduce usefulness of information because users of financial statements would still be able to obtain information on *total hedge ineffectiveness* for the period from the disclosures (eg paragraph 24C of IFRS 7 requires disclosure of hedge ineffectiveness by types of hedges). Similarly, applying paragraph 57 of the Exposure Draft results with all gains or losses for the period for one hedging instrument be classified in the same category ie the category affected by the risk managed with that hedging instrument, unless it involves a grossing-up of gains or losses, in which case the entity classifies in the default category. [5]	We recommend no changes to the proposals.

[5] If the Board agrees with the staff recommendations in this paper, the default category will be the operating category.

Feedback	Staff analysis	Recommendations
Presentation of gains or losses from derivatives and hedging instruments (paragraphs 57 and 58 of the Exposure Draft)		
A few respondents suggested the Board should also address presentation into line items of the gains or losses from derivatives and hedging instruments, noting that there is diversity in practice in relation to presentation of such items.	We acknowledge respondents' comments that developing presentation requirements would address the diversity in practice and increase comparability. However, as noted in paragraph B43 of the Exposure Draft, the Board limited the scope of proposals in paragraphs 57–59 of the Exposure Draft only to classification. The proposals do not prescribe in which line item such income and expenses should be included nor do they override the requirements of other IFRS Standards. This is consistent with the Board's overall approach in this project, which does not involve specifying what to include in the individual line items.	We recommend no changes to the proposals.
Classification of gains or losses on derivatives that are partly used for risk management (paragraphs 58 and 59 of the Exposure Draft)		
A few respondents asked the Board to provide guidance on classification of gains or losses on derivatives that are only partly used for risk management. For example, an interest rate swap with two legs separated whereby only one leg is designated for risk management purposes. These respondents asked whether the corresponding changes in fair value of the interest rate swap should be split between the two legs and classified separately or classified in one single location (eg in the investing category applying the Board's proposal in paragraph 59 of the Exposure Draft).	In our view, in the example described by respondents, the entity would apply paragraph 59 of the Exposure Draft and classify the gains or losses on the interest rate swap as a whole in the default category. As discussed in paragraph 58 the proposals do not address disaggregation of gains or losses from a single derivative.	We recommend no changes to the proposals.

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 fair value gains or losses on derivatives and hedging instruments.

B2. Some participants said that information was not available in current systems to classify gains or losses on derivatives 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 gains or losses on derivatives 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 gains or losses on derivatives. 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 gains or losses on derivatives in the categories proposed in the Exposure Draft because their existing systems already track the underlying sources.