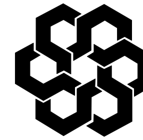

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**16 November 2006, London**
Project:	**Annual improvement process**
Topic:	**Classification of the liability component of a convertible instrument (Agenda Paper 2C)**

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1. The IFRIC have recommended that the following issue would be most appropriately resolved via the annual improvements process (as agreed by the Board in July 2006).

   Issue: Should the liability component of a convertible instrument with an obligation to deliver cash or other assets more than 12 months from the balance sheet date be classified as current or non-current*?*

2. The purpose of this paper is to propose that the above issue be added to the Board's annual improvements project, to provide analysis on that issue and to propose a solution.

Staff recommendation

3. The staff recommends that:

- the Board should add the issue described in paragraph 1 to the annual improvements project;
- the liability component of a convertible instrument with an obligation to deliver cash or other assets more than 12 months from the balance sheet date should be classified as non-current; and
- IAS 1 *Presentation of Financial Statements* should be amended in accordance with the proposed drafting in paragraph 17 of this paper.

Structure of the paper

4. The background to this issue, staff analysis and proposed drafting of amendments have been presented in the main body of this paper.

Background

5. In July 2006, the IFRIC was asked "to consider a situation in which an entity issued convertible financial instruments that, in accordance with IAS 32 *Financial Instruments: Presentation*, were accounted for as two elements – an equity component (ie the holders' rights to convert the instruments into a fixed number of equity instruments of the issuer <u>at any time</u> before the maturity date) and a liability component (ie the entity's obligation to deliver cash to holders at the maturity date, which was more than 12 months after the balance sheet date). The issue was whether the liability component should be presented as current or non-current on the face of the issuer's balance sheet."

6. The IFRIC observed that "both IAS 1 *Presentation of Financial Statements* and the <u>*Framework for the Preparation and Presentation of Financial Statements*</u> (the Framework) state that information about the liquidity and solvency of an entity is useful to users. The IFRIC also noted that the definitions of liquidity and solvency refer to the availability of cash to the

entity. On that basis, the IFRIC believed that the liability component should be classified as non-current." This is the approach adopted in practice.

7. However, the IFRIC also noted "paragraph 60(d) of IAS 1 states that a liability should be classified as current if the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date. According to paragraph 62 of the Framework, conversion of an obligation into equity is considered as the settlement of a liability. In addition, according to the definition of a financial liability set out in paragraph 16 of IAS 32, a financial liability may be settled through the delivery of a variable number of the issuer's own equity instruments. Settlement of a liability is not confined to delivery of cash or other assets." (Refer Appendix which sets out the various IFRS paragraphs in full.)

8. The IFRIC believed that "the above IFRS requirements appear to be in conflict. In addition, the IFRIC observed that practice, in determining whether the liability component was classified as current or non-current, focused on when the issuer was obliged to deliver cash or other assets. The IFRIC decided not to take the issue onto the agenda. Instead, the IFRIC believed that clarification from the Board on this issue was required."

Staff Analysis

Should the liability component of a convertible instrument with an obligation to deliver cash or other assets more than 12 months from the balance sheet date be classified as current or non-current?

9. The staff believe that the purpose of current or non-current classification on the balance sheet is to assist users in assessing the liquidity and solvency of an entity. Paragraph 56 of IAS 1 states that 'information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity'. Paragraph 16 of the Framework states that information about liquidity and solvency is useful in predicting the ability of the entity to meet its financial commitments as they fall due.

10. In accordance with paragraph 16 of the Framework, 'liquidity' refers to the availability of cash in the near future after taking account of financial

commitments over this period, and 'solvency' refers to the availability of cash over the longer term to meet financial commitments as they fall due.

11. These concepts focus on the entity's cash position. In the context of the classification of the liability component of a convertible instrument, these concepts are concerned with when the entity is obliged to deliver cash or other assets to settle the liability. The possibility that the liability will be settled within the next 12 months through delivery of an equity instrument is not relevant in determining an entity's liquidity position. This is because the issue of equity does not result in an outflow of cash or other assets of the entity.

12. However, a literal reading of the requirements of IAS 1 and the Framework would classify the liability component of a convertible instrument with an obligation to deliver cash or other assets more than 12 months from the balance sheet date as current where the instrument is convertible at any time.[1] However, there does not appear any basis for this result.

13. Practice consistently classifies the liability component in these situations as non-current on the grounds that non-current classification on the face of the balance sheet better reflects the entity's liquidity position.

Staff recommendation

14. The staff believe that the classification of the liability component of a convertible instrument as non-current better reflects the liquidity position of an entity. IAS 1 and the Framework state that information about the liquidity and solvency positions of an entity is useful and the terms 'liquidity' and 'solvency' are associated with the availability of cash of an entity.

15. The staff recommend that paragraph 60(d) of IAS 1 be amended to state that a liability will be classified as current when the entity does not have an unconditional right to defer the delivery of cash or other assets to settle the obligation for at least 12 months after the balance sheet date.

[1] As discussed in paragraph 7.

16. **Does the Board agree?**

Drafting

17. The following revisions are proposed to IAS 1 *Presentation of Financial Statements* should the Board agree with the staff recommendations:

Balance sheet

Current liabilities

60 A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the entity's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the balance sheet date; or

(d) the entity does not have an unconditional right to defer ~~settlement of the liability~~ delivery of cash or other assets to settle the obligation for at least twelve months after the balance sheet date.

All other liabilities shall be classified as non-current.

Basis for Conclusions

Classification of the Liability Component of Convertible Instruments

BC1 The Board considered the classification of the liability component of a convertible instrument with an obligation to deliver cash or other assets more than 12 months from the balance sheet date. The previous requirements of IAS 1.60(d) stated that where an entity did not have an unconditional right to defer settlement of the liability, the liability should be considered as current.

BC2 The Board noted that the *Framework for the Preparation and Presentation of Financial Statements* (the Framework) considers the conversion of an obligation into equity to be the settlement of a liability. IAS 1 and the Framework state that information about the liquidity and solvency positions of an entity is useful and the terms 'liquidity' and 'solvency' are associated with the availability of cash of an entity.

BC3 The Board concluded that classifying the liability as non-current better reflects the liquidity position of an entity and has amended IAS 1.60(d) accordingly.

Appendix

18. The IFRS paragraphs referred to in paragraph 7 have been reproduced below:

IAS 1 *Presentation of Financial Statements*

60 A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the entity's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the balance sheet date; or

(d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

All other liabilities shall be classified as non-current.

Framework for the Preparation and Presentation of Financial Statements

62 The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

IAS 32 Financial Instruments: Presentation

16 When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

    (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

    (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.