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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 June 2007, London**
Project:	**Annual Improvements**
Subject:	**IAS 1 – Current or non-current presentation of derivatives that are not designated as hedging instruments (Agenda paper 12C)**

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1. The IFRIC has recommended that the following issue would be most appropriately resolved via the annual improvements process.

   Issue: Should the guidance in IAS 1, *Presentation of Financial Statements*, relating to the classification as current or non-current of a financial liability that is classified as trading in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*, be clarified?

Staff recommendation

2. The staff recommends that the Board:

   - should add this issue to the annual improvements project; and
   - should amend IAS 1 as proposed in paragraph 15 of this paper.

Background

3. The IFRIC was requested to provide guidance on the current / non-current classification of derivatives that are not designated and effective hedging instruments.

4. Paragraph 9 of IAS 39 defines financial instruments held for trading as follows:

   'A financial asset or financial liability is classified as held for trading if it is:
   (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
   (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
   (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).'

5. Parts (i) and (ii) of the definition above include a reference to short-term buying and selling of the instruments. However, part (iii) includes all derivatives that are not designated and effective hedging instruments. Consequently a derivative that is not a designated and effective hedging instrument but which has a maturity of more than 12 months and is expected to be held for at least 12 months will be classified as trading.

6. Paragraphs 51 to 67 of IAS 1 provide guidance on the classification of assets and liabilities as current or non-current. These paragraphs are included as Appendix A to this paper for information. The current classification is required to be used when any of the criteria set out in paragraph 57 of IAS 1 (for assets) and paragraph 60 of IAS 1 (for liabilities) is met. These paragraphs are reproduced below:

   <u>Paragraph 57 of IAS 1:</u>
   An asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is expected to be realised within twelve months after the balance sheet date; or
(d) it is cash or a cash equivalent (as defined in IAS 7 *Cash Flow Statements*) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.
All other assets shall be classified as non-current.

<u>Paragraph 60 of IAS 1:</u>
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.

7. Applying the guidance set out in paragraphs 57 and 60 of IAS 1 to a derivative that is not a designated and effective hedging instrument but which has a maturity of more than 12 months and is expected to be held for at least 12 months leads to a non-current classification.

8. However, paragraph 62 provides as an example of a current liability 'financial liabilities classified as held for trading in accordance with IAS 39'. This guidance appears to require a current classification for a derivative financial liability that is not a designated and effective hedging instrument but which has a maturity of more than 12 months and is expected to be held for at least 12 months. This appears to conflict with the guidance in paragraph 60 of IAS 1.

IFRIC discussions

9. The IFRIC discussed the issue and considered three alternative ways of classifying derivatives:

   - Alternative 1 – the current or non-current presentation should be based on the requirements in IAS 1 paragraphs 51 – 62.
   - Alternative 2 – all derivatives that are classified as held for trading in accordance with IAS 39 should be presented as current on the face of the balance sheet; and
   - Alternative 3 – all derivatives that are classified as held for trading in accordance with IAS 39 should be presented as current on the face of the balance sheet, subject to some exceptions.

   A copy of the IFRIC paper presented and discussed at the March 2007 IFRIC meeting is included as Appendix B to this IASB paper for information [Appendix B is omitted from these Observer Notes].

10. The IFRIC identified the apparent inconsistency in the guidance within paragraphs 51 to 62 of IAS 1 in relation to such derivatives and therefore decided not to take the issue on to its agenda. However, it noted that some believe that IAS 1 paragraph 62 could be read as implying that financial liabilities that are classified as held for trading in accordance with IAS 39 are required to be presented as current. Therefore, the IFRIC directed the staff to recommend to the Board an amendment to IAS 1 paragraph 62 to remove that implication.

11. The staff agrees with the IFRIC that paragraph 62 of IAS 1 should be amended to remove the implication that financial liabilities that are classified as held for trading in accordance with IAS 39 are required to be presented as current.

12. The proposed amendment set out in paragraph 15 of this paper will result in the classification of a derivative financial liability as current on the basis of the criteria set out in paragraph 60 of IAS 1 rather than based on the classification as 'trading' in accordance with IAS 39. The proposed amendment is therefore consistent with the Board's decision to amend IAS 1 in respect of the classification of the liability component of a convertible instrument. The basis for the Board's conclusions in that case was that 'classifying the liability [as

current or non-current] based on the requirements to transfer cash or other assets better reflects the liquidity and solvency position of an entity'.

Staff recommendation

13. The staff recommends that IAS 1 is amended as proposed in paragraph 15 of this paper to remove the implication that financial liabilities that are classified as held for trading in accordance with IAS 39 are required to be presented as current.

14. **Does the Board agree?**

Drafting

15. The staff recommend that IAS 1 should be amended as follows:

Current liabilities

62 Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the balance sheet date or held primarily for the purpose of being traded. Examples are financial liabilities held primarily for the purpose of being traded ~~classified as held for trading in accordance with IAS 39~~, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the balance sheet date are non-current liabilities, subject to paragraphs 65 and 66.

Basis for Conclusions on Proposed Amendments to IAS 1 Presentation of Financial Statements

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Current liabilities

BC1 The Board has identified inconsistent guidance in IAS 1 regarding the current / non-current classification of derivatives that are not designated and effective hedging instruments. The guidance included in paragraph 62 of IAS 1 might be read by some as implying that financial liabilities that are classified as held for trading in accordance with IAS 39 are required to be presented as current.

BC2 The Board has decided to address this inconsistency by amending the examples of current liabilities that are given in paragraph 62 of IAS 1.

Appendix A: IAS 1 Guidance on Current / Non-current Classification

Current/non-current distinction

51 **An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its balance sheet in accordance with paragraphs 57–67 except when a presentation based on liquidity provides information that is reliable and is more relevant. When that exception applies, all assets and liabilities shall be presented broadly in order of liquidity.**

52 **Whichever method of presentation is adopted, for each asset and liability line item that combines amounts expected to be recovered or settled (a) no more than twelve months after the balance sheet date and (b) more than twelve months after the balance sheet date, an entity shall disclose the amount expected to be recovered or settled after more than twelve months.**

53 When an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities on the face of the balance sheet provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity's long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period.

54 For some entities, such as financial institutions, a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and is more relevant than a current/non-current presentation because the entity does not supply goods or services within a clearly identifiable operating cycle.

55 In applying paragraph 51, an entity is permitted to present some of its assets and liabilities using a current/non-current classification and others in order of liquidity when this provides information that is reliable and is more relevant. The need for a mixed basis of presentation might arise when an entity has diverse operations.

56 Information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity. IFRS 7 *Financial Instruments: Disclosures* requires disclosure of the maturity dates of financial assets and financial liabilities. Financial assets include trade and other receivables, and financial liabilities include trade and other payables. Information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and provisions is also useful, whether or not assets and liabilities are classified as current or non-current. For example, an entity discloses the amount of inventories that are expected to be recovered more than twelve months after the balance sheet date.

Current assets

57 **An asset shall be classified as current when it satisfies any of the following criteria:**

(a) **it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;**

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

(c) **it is expected to be realised within twelve months after the balance sheet date; or**

(d) **it is cash or a cash equivalent (as defined in IAS 7 *Cash Flow Statements*) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.**

All other assets shall be classified as non-current.

58 This Standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.

59 The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months. Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the balance sheet date. Current assets also include assets held primarily for the purpose of being traded (financial assets within this category are classified as held for trading in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*) and the current portion of non-current financial assets.

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 for at least twelve months after the balance sheet date.**

All other liabilities shall be classified as non-current.

61 Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. Such operating items are classified as current liabilities even if they are due to be settled more than twelve months after the balance sheet date. The same normal operating cycle applies to the classification of an entity's assets and liabilities. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

62 Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the balance sheet date or

held primarily for the purpose of being traded. Examples are financial liabilities classified as held for trading in accordance with IAS 39, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the balance sheet date are non-current liabilities, subject to paragraphs 65 and 66.

63 An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the balance sheet date, even if:

(a) the original term was for a period longer than twelve months; and

(b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue.

64 If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the balance sheet date under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no agreement to refinance), the potential to refinance is not considered and the obligation is classified as current.

65 When an entity breaches an undertaking under a long-term loan agreement on or before the balance sheet date with the effect that the liability becomes payable on demand, the liability is classified as current, even if the lender has agreed, after the balance sheet date and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. The liability is classified as current because, at the balance sheet date, the entity does not have an unconditional right to defer its settlement for at least twelve months after that date.

66 However, the liability is classified as non-current if the lender agreed by the balance sheet date to provide a period of grace ending at least twelve months after the balance sheet date, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

67 In respect of loans classified as current liabilities, if the following events occur between the balance sheet date and the date the financial statements are authorised for issue, those events qualify for disclosure as non-adjusting events in accordance with IAS 10 *Events after the Balance Sheet Date*:

(a) refinancing on a long-term basis;

(b) rectification of a breach of a long-term loan agreement; and

(c) the receipt from the lender of a period of grace to rectify a breach of a long-term loan agreement ending at least twelve months after the balance sheet date.

Appendix B: Paper presented to March 2007 IFRIC Meeting

[Appendix omitted from Observer Notes]