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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting:	**March 2007, London**
Project:	**Current or non-current presentation of derivatives that are not designated as hedging instruments in effective hedges (Agenda Paper 9(ii))**

ISSUE

1. The IFRIC has been asked for guidance on whether derivatives that are not designated as hedging instruments under IAS 39 should be presented as current or non-current on the face of the balance sheet. Such derivatives may be settled more than one year after the balance sheet date.

2. IAS 39 paragraph 9 requires derivatives that are not designated as hedging instruments under IAS 39 to be classified as held for trading and be measured at fair value through profit or loss. Derivatives that are classified as held for trading in accordance with IAS 39 include at least the following types:

   (a) derivatives acquired or incurred principally for the purpose of selling or repurchasing in the near future;
   (b) derivatives that are acquired for economic hedge purposes but hedge accounting is not used because:

- the fair value option under IAS 39 is adopted to address the accounting mismatch; or
- hedge accounting under IAS 39 is considered unnecessary because the hedged items have already been recognised at fair value through profit or loss; or
- the criteria for hedge accounting under IAS 39 are not met; and

(c) embedded derivatives that are required to be separately accounted for from the host contracts (see IAS 39 paragraph 11).

3. [Paragraph omitted from observer note].

SCOPE OF THIS PAPER

4. This paper does not aim to address derivatives that are held primarily for the purpose of being traded, which are required to be classified as current in accordance with IAS 1 paragraphs 57 and 60. Nor does this paper address derivatives that are due to be settled within one year after the balance sheet date, which again are required to be presented as current under IAS 1.

STAFF ANALYSIS

5. This paper illustrates three different alternatives:

- 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.

6. For each alternative, this paper discusses the possible ways to take the issue forward.

7. None of the above alternatives suggest that the issue should be taken onto the agenda. Instead, all of them suggest amendments to IAS 1 through the Board's Annual Improvements Process. Proposed amendments to IAS 1 for each alternative are different.

Alternative 1: Current or non-current presentation should be based on the requirements in IAS 1 paragraphs 51 - 62

8. IAS 39 requires derivatives not designated as hedging instruments in effective hedges to be classified as held for trading. However, supporters of Alternative 1 believe that classifying those derivatives as held for trading under IAS 39 is solely <u>for measurement purposes</u>.

9. Supporters of Alternative 1 note that ‘a financial asset or a financial liability that s acquired or incurred principally for the purpose of selling or repurchasing in the near future’ is shown as a standalone category in IAS 39 paragraph 9.

10. In addition, proponents of Alternative 1 note that the purpose of presenting current and non-current information on the face of the balance sheet is to provide users with information about the liquidity and solvency of an entity (see IAS 1 paragraph 56). Therefore, they believe that entities should look at the requirements in IAS 1 in determining whether derivatives in the scope of this paper should be presented as current or non-current on the face of the balance sheet.

11. Relevant requirements in IAS 1 are as follows:

> In accordance with IAS 1 paragraph 57(c), derivative assets should be presented as current when they are expected to be realised within twelve months after the balance sheet date. In all other circumstances, they should be presented as non-current. Requirements in IAS 1 paragraphs 57(a), (b) and (d) are not relevant in determining the presentation of derivatives that are in the scope of this paper.
>
> Based on IAS 1 paragraph 60(d), derivative liabilities should be presented as current unless an entity has an unconditional right to defer settlement for at least twelve months after the balance sheet date. Requirements in IAS 1 paragraphs 60(a), (b) and (c) are not relevant in determining the presentation of derivatives that are in the scope of this paper.
>
> Moreover, 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, IAS 1

paragraph 52 requires an entity to disclose the amount expected to be recovered or settled after more than twelve months.

12. IAS 39 paragraph 75 states '…a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.' IAS 39 does not allow the bifurcation of a single fair value derivative for hedge accounting purposes. Consequently, opponents of Alternative 1 argue that it is not permitted to split the fair value of a derivative into an amount that will be settled within one year from the balance sheet date and an amount that will be settled more than one year after the balance sheet date.

13. Supporters of Alternative 1 argue that the requirement in IAS 39 paragraph 75 is relevant for hedge designation purposes. In determining the current and non-current presentation of derivatives, entities should consider the requirements in IAS 1. In other words, the requirement in IAS 39 has no effect on current or non-current presentation of derivatives.

14. Indeed, supporters of Alternative 1 believe that theoretically it is feasible with some valuation techniques to split the carrying amounts of derivatives into current and non-current components. For example, the current component of a five-year interest rate swap with interest payments exchanged quarterly is the present value of the net interest cash flows of the swap for the forthcoming twelve months after the balance sheet date.

15. Alternative 1 requires that current or non-current presentation of a derivative should be determined based on when the cash flows of the derivative will be transferred. If the contractual terms of the derivative specify when the cash flows will be transferred, the balance sheet presentation should be determined in accordance with the relevant contractual terms. However, if a derivative does not involve any cash flows (e.g. an option to buy or sell an asset), management should determine when the derivative will be settled for current or non-current presentation purposes. Management knows why derivatives are entered into and when derivatives are expected to be settled.

The way forward (if Alternative 1 is adopted)

16. If the IFRIC wishes to proceed with Alternative 1, the staff believes that the issue should not be taken onto the agenda.

17. The staff believes that the IFRIC should not address how to split the carrying amount of a derivative into current and non-current components. To address that question, Application Guidance (rather than an Interpretation) would be required.

18. [Paragraph omitted from observer note].

19. [Paragraph omitted from observer note].

Alternative 2 – 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

20. Under Alternative 2, derivatives that are not designated as hedging instruments under IAS 39 should all be presented as current on the face of the balance sheet - to be consistent with the classification requirement under IAS 39. Under IAS 39, derivatives that are designated as hedging instruments are deemed as held for trading for measurement purposes.

21. Alternative 2 has the advantage of being simple to apply. Entities do not have to consider whether the carrying amount of a single fair value derivative should be split for the balance sheet presentation purposes, and if so how. Supporters of Alternative 2 note that: on the one hand IAS 1 paragraph 52 requires entities to split the carrying amount of an asset or a liability as appropriate and on the other hand IAS 39 paragraph 75 generally does not allow entities to bifurcate the carrying amount of a single fair value derivative[1].

22. In addition, proponents of Alternative 2 believe that the current presentation reflects the fact that derivatives are highly liquid in nature (though some may argue that this is not the purpose of presenting current and non-current information on the face of the balance sheet).

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[1] Supporters of Alternative 2 believe that a possible reason for why entities are not allowed to designate a derivative as a hedging instrument for part of its life is that gains and losses on derivative hedging instruments should be based on objectively determined market amounts (rather than amounts separated out from overall gains or losses on the derivatives). They ask, if the carrying amount of a single fair value derivative is not allowed to be bifurcated for hedge accounting purposes, why the carrying amount of a derivative would be allowed to be split into current and non-current components for the balance sheet presentation purposes.

23. Moreover, supporters of Alternative 2 note that IFRS 7 *Financial Instruments: Disclosures* requires disclosures of maturity dates of financial assets and financial liabilities. They believe that such disclosures in accordance with IFRS 7 provide users with information about the liquidity and solvency of an entity. Consequently, they believe that it is still appropriate to deem the derivatives that are classified as held for trading in accordance with IAS 39 as held for trading for current or non-current presentation purposes (as long as the information about an entity's liquidity is disclosed somewhere in the notes to the financial statements).

24. For example, for an equity-indexed interest payment derivative embedded in a host debt that is repayable in five annual instalments, supporters of Alternative 2 believe that the most useful information from the users' perspective is that future interest payments are based on the price of the equity instruments of the entity (rather than the current or non-current presentation of the embedded derivative).

The way forward (if Alternative 2 is adopted)

25. [Paragraph omitted from observer note].

Alternative 3 – Derivatives that are classified as held for trading under IAS 39 should be presented as current on the face of the balance sheet, subject to some exceptions

26. As mentioned above, not all derivatives that are classified as held for trading under IAS 39 are held primarily for the purpose of being traded. Therefore, similarly to Alternative 1, Alternative 3 accepts that it may not be appropriate to present as current all derivatives that are not designated as hedging instruments in accordance with IAS 39.

27. However, unlike Alternative 1, Alternative 3 supports the view that the carrying amount of a single fair value derivative should not be split for current or non-current presentation purposes. Therefore, Alternative 3 suggests that derivatives that contain both current and non-current components should in their entirety be presented as current (i.e. no split of the carrying amounts).

28. Alternative 3 suggests that the following derivatives should be presented as non-current:

(a) derivatives whose cash flows are expected to be transferred more than one year after the balance sheet date based on the contractual terms of the derivatives, for example foreign currency forward contracts that are to be settled five years after the balance sheet date;
(b) derivatives that are entered into for economic hedge purposes but hedge accounting is not used because there is no accounting mismatch or the accounting mismatch has been addressed by the fair value option under IAS 39, when the ‘economically hedged items’ in their entirety are presented as non-current; and
(c) embedded derivatives that are separately accounted for from the relevant host contracts, when the host contracts in their entirety are presented as non-current.

All other derivatives that are classified as held for trading in accordance with IAS 39 should be presented as current.

<u>Derivatives entered into for economic hedge purposes</u>

29. Proponents of Alternative 3 note that the fair value option set out in IAS 39 paragraph 9 is sometimes used as an alternative to hedge accounting. For example, when a derivative is entered into as an economic hedge of a financial instrument that is not measured at fair value through profit or loss, an entity can designate the financial instrument on its initial recognition as at fair value through profit or loss to address the recognition and measurement accounting mismatch.

30. In addition, proponents of Alternative 3 note that, when financial instruments are designated as at fair value through profit or loss on the initial recognition, entities are required to disclose how they have satisfied the fair value option criteria in their financial statements (see IAS 39 paragraph 9).

31. Therefore, where the fair value option under IAS 39 is used as an alternative to hedge accounting, supporters of Alternative 3 believe that the presentation of derivative hedging instruments should be the same as that of the hedged items. In other words, when the hedged items in their entirety are presented as non-current, the derivative hedging instruments should also be presented as non-current.

32. In situations in which entities enter into derivatives for economic hedge purposes but hedge accounting is not used because the hedge accounting criteria in IAS 39 have not been met, Alternative 3 suggests that those derivatives should be deemed as held for trading for current and non-current presentation purposes.

Embedded derivatives separately accounted for from the host contracts

33. Embedded derivatives cannot normally be sold independently from their host contracts (even though they may not be closely related to the host contracts and be required to be separately accounted for).

34. For this reason, supporters of Alternative 3 believe that the presentation of the embedded derivatives should be consistent with that of the host contract. Therefore, when the host contracts in their entirety are presented as non-current, the embedded derivatives should also be presented as non-current. In other cases, the embedded derivatives should be presented as current.

35. However, some argue that since such embedded derivatives are separately accounted for from the host contracts, the current or non-current presentation of embedded derivatives should depend on the requirements in IAS 1 – that means not necessarily be consistent with the presentation of the host contracts.

Derivatives that do not involve any cash flows

36. Derivatives that do not involve any cash flows (e.g. options to buy or sell assets) would be required under Alternative 3 to be deemed as held for trading for the current or non-current presentation purposes.

The way forward (if Alternative 3 is adopted)

37. If View 3 was adopted, the staff believes that the issue should be referred to the Board for amendments to IAS 1.

38. This paper provides a list of circumstances in which derivatives that are classified as held for trading in accordance with IAS 39 should be presented as non-current (see paragraph 33 in this paper). The staff would like to seek the IFRIC's comments on whether it would like to add or delete any

circumstances from the list. Therefore, at this stage, the staff has not developed any detailed amendments to IAS 1 necessary for Alternative 3.

39. [Paragraph omitted from observer note].

40. [Paragraph omitted from observer note].

STAFF RECOMMENDATION

41. [Paragraph omitted from observer note].

42. Proposed 'rejection' wording in favour of Alternative 1 is set out below: [Proposed 'rejection' wording omitted from observer note].

QUESTIONS TO THE IFRIC

43. Which alternatives does the IFRIC wish to pursue? The three possible alternatives available to the IFRIC are:
    - Alternative 1 – the Current or non-current presentation of derivatives that are classified as held for trading in accordance with IAS 39 should be solely based on the requirements in IAS 1;
    - Alternative 2 – Derivatives that are classified as held for trading in accordance with IAS 39 should all be presented as current to be consistent with the classification requirement in IAS 39; and
    - Alternative 3 – Derivatives that are classified as held for trading in accordance with IAS 39 should be presented as current subject to some exceptions.

44. How does the IFRIC wish to address the issue? Does the IFRIC believe that amending IAS 1 is sufficient to address the issue (i.e. no development of any Interpretation)?

45. If the IFRIC wishes to proceed with Alternative 3, does the IFRIC believe that the circumstances in which derivatives should be presented as non-current should be restricted to those set out in paragraph 33 of this paper? Are there any circumstances that the IFRIC wishes to add or delete?

46. If the IFRIC does not wish to pursue either one of the alternatives set out in this paper, what approach would the IFRIC like to pursue?

APPENDIX 1 – THE SUBMISSION [OMMITTED FROM OBSERVER NOTE]