Technical Accounting Alert

Classification of derivatives as current or non-current

Introduction

The purpose of this alert is to ascertain whether assets and liabilities arising from derivative financial instruments ("derivatives") should be classified in the statement of financial position as current or non-current.

Note

On November 12 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 30. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 30. Work has begun on phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 WAS ISSUED IN AUSTRALIA AS AASB 9 FINANCIAL INSTRUMENTS WITH AN EFFECTIVE DATE OF 1 JANUARY 2013 AND THEREFORE AASB 9 REQUIREMENTS HAVE NOT BEEN CONSIDERED FOR THE PURPOSE OF THIS ALERT.

Relevant Australian Standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 1 Presentation of Financial Statements	AASB 101 Presentation of Financial Statements
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement

Overview

IAS 39 addresses the measurement of derivatives, including embedded derivatives. It requires that derivatives are reported at fair value through profit or loss (or fair value through equity for the effective portion of derivatives designated as hedging instruments in a cash flow hedge). Derivatives therefore give rise to assets or liabilities.

IAS 1 addresses the presentation of financial statements. It generally requires the presentation of current and non-current assets and liabilities as separate classifications on the face of the statement of financial position (IAS 1.51). Derivative assets and liabilities therefore need to be classified as either current or non-current items.

IAS 1.59 indicates a link between IAS 39's classification requirements and IAS 1's presentation requirements. It should not be presumed that derivatives are held primarily for the purpose of being traded.

Many entities acquire derivatives for hedging purposes rather than for trading. Some derivatives might be formally designated in hedging relationships in accordance with IAS 39's hedge accounting requirements. Other derivatives might be regarded as "economic hedges" ie part of a hedging relationship that does not qualify for IAS 39 hedge accounting or for which management has decided not to adhere to IAS 39's strict documentation and effectiveness testing conditions.

Current v non-current classification

AASB 101 provides the following criteria for determining current classification:

- **assets and liabilities** that are held primarily for the purposes of being traded; or
- **assets** that are (i) expected to be realised within 12 months of the reporting date; or (ii) expected to be realised, or are intended for sale/consumption, in the entity's normal operating cycle (if this is not 12 months and is clearly identifiable);
- **liabilities** that are (i) due to be settled within 12 months of the reporting date; or (ii) expected to be settled within the entity's normal operating cycle (if this is not 12 months and is clearly identifiable); or (iii) for which the entity does not have the unconditional right to defer settlement beyond 12 months.

Detailed guidance

Free-standing derivatives (ie derivatives other than embedded derivatives) not designated as a hedge

Grant Thornton's preferred view is that free-standing derivatives (ie derivatives other than embedded derivatives) that are not formally designated as hedging instruments should be classified as current or non-current based on the normal IAS 1.57 and 60 criteria.

When **no formal hedge designation** is made, the entity should look to the contractual date of settlement (or realisation) of non-trading derivatives. This is straightforward in cases when the derivative is realised or settled at a fixed future date (for example: contracts to buy or sell foreign currency at a future date, "European-style" options that are exercisable only on a single date). In other cases, the derivative might be settled or realised:

- through periodic payments or receipts (eg an interest swap in which the interest differential is paid or received monthly for the duration of the contract); or
- over a range of dates at the discretion of one of the parties (eg option contracts that can be exercised by the purchaser at any time between purchase and expiry, sometimes referred to as "American-style" options).

In the first case, it may be necessary to split the fair value of the derivative into a current and non-current portion. In the second case, the purchaser of the option (ie the asset-holder) should look to its **expected** date of exercise. However, the issuer (writer, being the party with a liability) should classify its obligation as current since it can be required to settle the contract at any time before expiry.

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Derivatives that are formally designated as hedging instruments

Derivatives that are formally designated as hedging instruments should normally be classified as current if the hedging relationship expires within 12 months of the reporting date and as non-current if the hedging relationship expires after more than 12 months. This will often correspond with the period to expiry or settlement/realisation of the derivative, but not always.

However, we consider that it is also acceptable to adopt a policy of classifying **all** free-standing derivatives as current assets or current liabilities.

Embedded derivatives

The classification of embedded derivatives and the associated host contract should be determined as a whole, based on the terms and conditions of the combined contract.

IAS 39.11 requires that many **embedded derivatives** are separated from their **host contract** and accounted for as free-standing derivatives. In Grant Thornton's view, this requirement is intended to ensure appropriate measurement of embedded derivatives and does not affect their classification as current or non-current. IAS 39.11 also explicitly states that "this Standard does not address whether an embedded derivative shall be presented separately on the face of the financial statements".

Embedded derivatives cannot be settled or realised independently of the host contract. In other words, the combined contract is settled, realised or traded as a whole. We therefore believe that the classification of combined contracts should be considered as a whole.

Applying this approach to the following examples of combined contracts, the **issuer** would classify the contract as follows:

- a five year bond with a separated embedded put option that allows the holder to put the bond back to the issuer in six months' time would be classified as a current liability. This is because the holder can require settlement within 12 months;
- a similar five year bond but with a call rather than a put (ie the issuer can call the bond in six months but the holder has no right to put it back to the issuer) would be classified as current if it expects to exercise the call, otherwise as non-current;
- a five year equity linked bond with no puts and calls but all the payments dependent on the performance of a specified equity index would be classified as non-current;
- a five year foreign exchange convertible (with no equity component) that can be converted quarterly at the option of the holder would be classified as current.

In some cases, the host contract might not be recognised in the statement of financial position at all. An example is a contract to buy or sell a non-financial item denominated in a foreign currency. In this case the entity should look to the date on which the contract as a whole is settled. In this example, this would probably be the date on which the non-financial item is expected to be delivered.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au