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International  
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Board

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*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

## INFORMATION FOR OBSERVERS

**IFRIC meeting:** July 2006, London

**Project:** IAS 1 *Presentation of Financial Statements - Whether the Liability Component of a Convertible Instrument should be classified as Current or Non-current* (Agenda paper 10(ix))

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## INTRODUCTION

1. The IFRIC has been asked to consider a situation in connection with the presentation of the liability component of a convertible instrument (i.e. current or non-current liability).
2. For example, on 1 January 20X1, Entity A issues a convertible instrument denominated in its own functional currency. In accordance with IAS 32 *Financial Instruments: Presentation*, the convertible instrument is accounted for as two components - an equity component (i.e. the holders' right to convert the instrument into a fixed number of equity instruments of the issuer any time before 31 December 20X5), and a liability component (i.e. the issuer's obligation to deliver cash to the holders on 31 December 20X5 if the holders do not exercise their conversion rights). The financial year of Entity A ends on 31 December each year.
3. The issue is whether the liability component should be presented as current or non-current on the face of the balance sheet as at 31 December 20X1. The

submission asked the IFRIC to provide guidance on how the liability component should be presented on the face of the balance sheet.

## **STAFF ANALYSIS**

4. IAS 32 and IFRS 7 *Financial Instruments: Disclosures* do not specify the requirements as to whether a financial liability should be presented as current or non-current. IFRS 7 requires disclosure of the maturity dates of financial liabilities. Therefore, it is necessary to look at the requirements of IAS 1 in determining whether a financial liability should be presented as current or non-current.
5. Paragraph 60 of IAS 1 states that a liability shall be classified as current when it satisfies one of the conditions below. All other liabilities shall be classified as non-current.
  - it is expected to be settled in the entity's normal operating cycle;
  - it is held primarily for the purpose of being traded;
  - it is due to be settled within twelve months after the balance sheet date; or
  - the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

The conditions set out in the first three bullets above are not relevant in respect of the above case. The key question indeed is whether the issuer has an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

### ***Arguments for current classification***

6. Paragraph 60(d) of IAS 1 states that a liability shall be classified as current when the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date. IAS 1 focuses on whether an entity has an unconditional right to defer "settlement" in determining whether an entity shall classify the liability as current or non-current.
7. Paragraph 62 of the Framework states that "settlement" of a present obligation may occur in a number of ways, e.g. by (i) payment of cash; (ii) transfer of other assets; (iii) provision of services; (iv) replacement of that obligation with another

obligation; or (v) conversion of the obligation to equity. In addition, based on the definition of a financial liability in IAS 32, a financial liability can be settled through (i) delivery of cash; (ii) delivery of a financial asset; or (iii) delivery of a variable number of an entity's own shares. Under the Framework and IAS 32, "settlement" of a liability is not confined to delivery of cash or other assets.

8. The above arguments suggest that the liability component should be presented as current on the face of the balance sheet.

#### ***Arguments for non-current classification***

9. However, some believe that the purpose of current or non-current classification on the balance sheet is to help users assess 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. In addition, 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. Supporters of non-current classification, therefore, believe that, in determining whether the liability component should be classified as current or non-current, the focus should be on when the entity is obliged to deliver cash or other assets. They believe that the possibility that the liability will be settled within the next twelve months through delivery of an equity instrument is not relevant in determining an entity's liquidity position.
11. For the above reasons, some believe that the liability component should be classified as non-current.
12. Some further suggest that split accounting, that is applicable to the recognition and measurement of elements of a compound financial instrument in accordance with IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement*, can also be applied to the classification issue. They say that, in determining whether

the liability component should be classified as current or non-current, the equity component of a convertible financial instrument should be ignored. The staff has reservations over this argument. The potential implication is that some elements of a compound financial instrument are classified as current while others of the same instrument are classified as non-current.

13. Take, for example, a debt instrument with an option that entitles the holder to require the issuer to pay early. Since the host debt and the embedded option are not closely related, they are accounted for separately in the financial statements of the issuer of the instrument in accordance with IAS 39. The host debt refers to the issuer's obligation to deliver cash at maturity date, say, five years from the balance sheet date. Based on the argument above (see paragraph 12 of this agenda paper), the host debt and the embedded option are classified differently. The host debt is classified as a non-current liability because the principal will be repayable five years later, whereas the embedded prepayment option is classified as current.
14. However, based on paragraph 60(d) of IAS 1, the host debt contract should be classified as current because the issuer does not have the unconditional right to defer settlement for at least twelve months from the balance sheet date.
15. Accordingly, the staff does not agree with the argument set out in paragraph 12 of this agenda paper.

#### **STAFF RECOMMENDATION**

16. On the one hand, in the staff's view, it is rather difficult to say that requirements under paragraph 1 of IAS 1 and paragraph 62 of the Framework are not clear. Based on those requirements, the liability component should be classified as current. On the other hand, it is generally expected that the non-current classification 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.
17. The Agenda Committee observed that practice consistently classifies the liability component in the illustrated situation as non-current on the grounds that non-

current classification on the face of the balance sheet better reflects an entity's liquidity position.

18. The staff believes that the requirements in IFRSs, in particular, among IAS 1 and the Framework, appear to be in conflict. The staff recommends that the issue should not be taken onto the agenda but should instead be referred to the Board for clarification<sup>1</sup>. Proposed wording for a recommendation is set out in paragraph 23 of this agenda paper.
19. At the current stage, the staff does not suggest the IFRIC to make any specific recommendations to the Board as to how relevant IFRSs should be amended. The staff believes that any changes to IFRSs require further detailed analysis.
20. The staff believes that no endorsement on either view should be given at this stage. The staff is concerned that, if the IFRIC were to suggest that current classification was required at this stage and then the Board were to amend IAS 1 in favour of non-current classification in the near future, it would create undesirable instability in the standard setting process and make it difficult for users to understand the successive sets of financial statements.
21. At its meeting in June 2006, the Agenda Committee agreed with the staff recommendation.

22. Does the IFRIC agree with the staff recommendation? If not, what recommendation would you make?
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23. [Paragraph omitted from observer notes]

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<sup>1</sup> The Board issued an exposure draft entitled *Amendments to IAS 1 Presentation of Financial Statements*. The deadline for comments is 17 July 2006.