MFRS Hot Topics

Classification of derivatives as current or non-current

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication discusses should assets and liabilities arising from derivative financial instruments (derivatives) be classified in the statement of financial position as current or non-current.

Relevant MFRS

MFRS 101 Presentation of Financial Statements

MFRS 139 Financial Instruments: Recognition and Measurement

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Guidance

Free-standing derivatives (i.e. derivatives other than embedded derivatives)

Free-standing derivatives (i.e. 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 MFRS 101.66 and 69 criteria. In summary these criteria require current classification for:

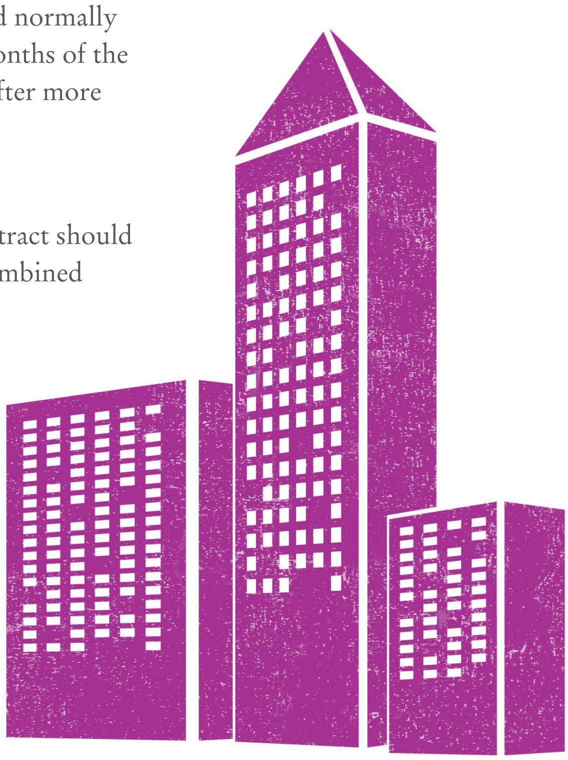
- **assets and liabilities** that are held primarily for the purposes of being traded or
- **assets** that are
  - (i) expected to be realised within 12 months of the reporting date; or
  - (ii) expected to be realised, or are intended for sale/consumption, in the entity's normal operating cycle (if 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.

Other free-standing derivatives should generally be classified as non-current

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.

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.



Discussion

Classification

MFRS 139 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.

MFRS 101 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 (also known as a classified statement of financial position) (MFRS 101.60), except when presentation based on liquidity provides information that is reliable and more relevant (in which case it shall present all assets and liabilities based on liquidity). Whichever method of presentation is adopted, an entity must disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item where it combines amounts expected to be recovered or settled no more than twelve months after the reporting period and more than twelve months after the reporting period. In our view, derivative assets and liabilities therefore need to be classified as either current or non-current items when presenting a classified statement of financial position.

MFRS 101 sets out various criteria to determine current versus non-current classification, primarily at MFRS 101.66 and 69. The main criteria are summarised in the guidance section.

It was sometimes argued that all derivative financial instruments should be regarded as 'held primarily for the purpose of being traded' because MFRS 139 includes derivatives in the 'held for trading' classification (MFRS 139.9). Our view is that MFRS 139's requirements are concerned with measurement and that the inclusion of derivatives in a held for trading category is intended to ensure that the appropriate measurement requirements are applied. In the context of classification as current or non-current in accordance with the definitions in MFRS 101.66 and 69, we consider that 'held primarily for the purpose of being traded' refers to management's reason for acquiring the asset or liability. However, it should not be presumed that all derivatives are held primarily for the purpose of being traded.

To clarify this point, the International Accounting Standards Board made a minor amendment to the examples of current assets and current liabilities in IAS 1.68 and 71 (equivalent to MFRS 101) as part of the Improvements to IFRSs project in 2007. The Basis for Conclusions of IAS 1 (BC38A to BC38D) was also amended to reaffirm that current assets and current liabilities may include some (but not necessarily all) financial instruments classified as held for trading in accordance with IAS 39 (equivalent to MFRS 139).

Many entities acquire derivatives for hedging purposes rather than for trading. Some derivatives might be formally designated in hedging relationships in accordance with MFRS 139's hedge accounting requirements. Other derivatives might be regarded as 'economic hedges' ie part of a hedging relationship that does not qualify for MFRS 139 hedge accounting or for which management has decided not to adhere to MFRS 139's strict documentation and effectiveness testing conditions.

When **a formal hedge designation** has been made, we consider that it is appropriate to look to the duration of the documented hedge relationship to determine the appropriate current or non-current classification. This will often correspond with the period to expiry or settlement/realisation of the derivative, but not always.

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 (e.g. 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 (e.g. 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.

Embedded derivatives

MFRS 139.11 requires that embedded derivatives meeting certain specified criteria are separated from their host contract and accounted for as free-standing derivatives. In our view, this requirement is intended to ensure appropriate measurement of embedded derivatives and does not affect their classification as current or non-current. MFRS 139.11 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 (i.e. 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 of the payments are 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, which is to be covered in the MFRS Hot Topics March 2017 issue. 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.

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