IAS 1: Application of Paragraph 76B to Classify Convertible Debt as Current or Non-current

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IAS 1 *Presentation of Financial Statements* contains guidance regarding the classification of liabilities as either current or non-current in an entity's financial statements. In January 2020, the International Accounting Standards Board (IASB) issued amendments to IAS 1 to clarify the criterion for classifying a liability as non-current relating to the right to defer settlement of the liability for at least 12 months after the reporting period. The IASB proposes that these amendments be effective for annual reporting periods beginning on or after January 1, 2023.[1]

The amendments introduce changes to several paragraphs in IAS 1, including paragraph 69(d) and the addition of paragraph 76B:

69 An entity shall classify a liability as current when:

(d) it does not have ~~an unconditional~~ the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period ~~(see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification~~.

76B Terms of a liability that could, at the option of the counterparty, result in its settlement by the transfer of the entity's own equity instruments do not affect its classification as current or non-current if, applying IAS 32 *Financial Instruments: Presentation*, the entity classifies the option as an equity instrument, recognising it separately from the liability as an equity component of a compound financial instrument.

Under the existing IAS 1, there is potential for diversity in practice because it is unclear whether the second sentence in paragraph 69(d) should be applied only to an equity-classified conversion feature, or whether the sentence could be applied more broadly to a conversion feature that is classified as a liability (see the Group's discussion in December 2014, "IAS 1 and IAS 32: Classification of Debt with Embedded Equity-linked Derivatives").

When the IASB issued the amendments to IAS 1, it also amended the Basis for Conclusions. Paragraph BC48H of the Basis for Conclusions states:

[1] The amendments were initially issued with an effective date for annual reporting periods beginning on or after January 1, 2022. However, in response to the COVID-19 pandemic, the IASB proposes to defer the effective date by one year, with earlier application permitted (see Exposure Draft, "Classification of Liabilities as Current or Non-current—Deferral of Effective Date" issued in May 2020).

> The Board concluded that, when it had added the statement about counterparty conversion options in 2009, it had intended the statement to apply only to liabilities that include a counterparty conversion option that meets the definition of an equity instrument and, applying IAS 32 *Financial Instruments: Presentation*, is recognised separately from the host liability as the equity component of a compound financial instrument. The Board further concluded that, in other cases—that is, if an obligation to transfer equity instruments is classified applying IAS 32 as a liability or part of a liability—the transfer of equity instruments would constitute settlement of the liability for the purpose of classifying it as current or non-current. To reflect those conclusions, the Board moved the statement about counterparty conversion options from paragraph 69(d) to new paragraph 76B and clarified its scope.

The Group considered the application of paragraph 76B of the amended IAS 1 to the financial instruments in the following three fact patterns.

Fact Pattern 1

An entity issues a convertible bond that matures in five years after the reporting date. The bond comprises:

- a financial liability (i.e., a contractual obligation to deliver cash to the holder of the bond); and
- an equity instrument (i.e., an option granted to the holder to convert the bond into a fixed number of the entity's ordinary shares at any time before maturity).

Issue 1: Is the following analysis appropriate in determining whether paragraph 76B of the amended IAS 1 affects the classification of the convertible bond as current or non-current?

Analysis

Based on paragraph 28 of IAS 32, the convertible bond is a compound financial instrument and the two components are recognized separately. Since the conversion feature is classified as an equity instrument, the holder's option to convert the liability to equity within 12 months does not affect the classification of the liability based on paragraph 76B of amended IAS 1.

The entity has a right to defer settlement for five years given the maturity period. As a result, the entity classifies the liability component as non-current in Years 1 to 4, and as current in Year 5.

The Group's Discussion

Group members agreed with the above analysis.

Fact Pattern 2

An entity issues a financial instrument that obliges it to transfer to the counterparty a variable number of its common shares equal to CU100 at the time of transfer. The instrument is due to be settled within six months after the reporting date.

Issue 2: Is the following analysis appropriate in determining whether paragraph 76B of amended IAS 1 affects the classification of the financial instrument as current or non-current?

Analysis

The financial instrument contains a contractual obligation to deliver a variable number of the entity's own equity instruments and, therefore, the obligation is classified as a liability. As a result, paragraph 76B of amended IAS 1 affects the classification of the financial instrument as current or non-current.

The entity is required to settle the financial instrument within six months after the reporting date and, therefore, classifies the financial instrument as a current liability.

The Group's Discussion

Group members agreed with the above analysis.

Fact Pattern 3

An entity issues a foreign currency convertible bond that matures in three years after the reporting date. The bond comprises:

- a financial liability (i.e., a contractual obligation to deliver foreign currency cash to the holder of the bond); and
- an option granted to the holder to convert the bond at any time into a fixed number of the entity's common shares.

Issue 3: Is the following analysis appropriate in determining whether paragraph 76B of amended IAS 1 affects the classification of the foreign currency convertible bond as current or non-current?

Analysis

Based on paragraph 11 of IAS 32, the bond is a financial liability. The conversion option is not an equity instrument because the entity must exchange a variable amount of cash (in its functional currency) for a fixed number of its own equity instruments. This means that the conversion option fails the fixed-for-fixed condition in IAS 32. Since the conversion option is not an equity instrument, paragraph 76B of amended IAS 1 affects the classification of the convertible bond as current or non-current.

The transfer of the entity's own equity instruments is considered a form of bond settlement and the counterparty can demand such settlement at any time. As a result, the entity does not have the right at the end of the reporting period to defer settlement of the liability for at least 12 months after the reporting date. Therefore, the entity classifies the host debt liability as current in all three years.

The Group's Discussion

Group members agreed with the above analysis.

Several Group members noted that while they agree with the analysis, they observe that the accounting outcome appears counterintuitive. For example, both Fact Patterns 1 and 3 have an equity-settled option. However, the classification of the convertible bond would differ based on whether the equity-settled option is classified as an equity instrument under IAS 32. While the distinction appears artificial, they acknowledge that this is the accounting outcome produced under the amendments to IAS 1. They also noted that these amendments would result in views that differ from those expressed at the Group's December 2014 meeting when the Group discussed a hybrid contract that contains a debt host component and an embedded derivative liability.

Another Group member noted that in Canada, there are many entities that issue foreign currency convertible bonds similar to what is considered in Fact Pattern 3. These amendments will likely result in current classification of these bonds and, therefore, may affect an entity's covenant requirements.

Overall, the Group's discussion of the three fact patterns raises awareness of the amendments to IAS 1 relating to classification of liabilities as current and non-current. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).