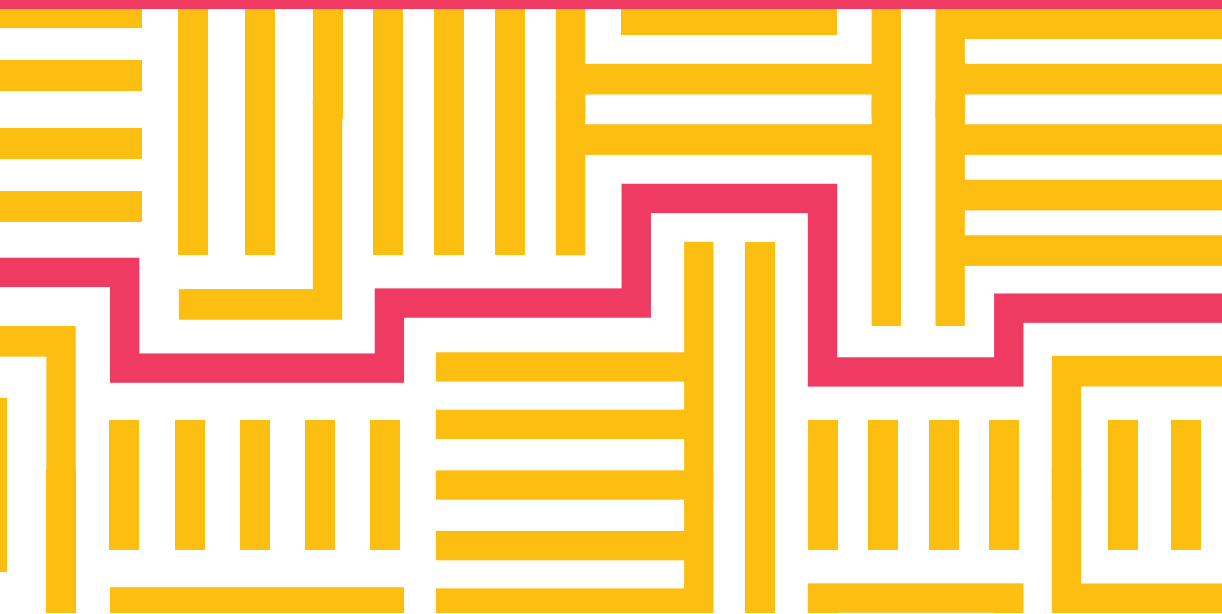


# IFRS news

February 2020



# A look at current financial reporting issues

## Classification of Liabilities as Current or Non-current (Amendment to IAS 1)

### At a glance

The IASB issued a narrow-scope amendment to IAS 1, 'Presentation of Financial Statements', to clarify that liabilities are classified as either current or non-current, depending on the rights that exist at the end of the reporting period. Classification is unaffected by the expectations of the entity or events after the reporting date (for example, the receipt of a waiver or a breach of covenant). The amendment also clarifies what IAS 1 means when it refers to the 'settlement' of a liability.

Entities should reconsider their existing classification in the light of the amendment and determine whether any changes are required.

### What is the issue?

On 23 January 2020, the IASB issued a narrow-scope amendment to IAS 1 to clarify that liabilities are classified as either current or non-current, depending on the rights that exist at the end of the reporting period. The amendment requires the following:

- Liabilities are classified as non-current if the entity has a substantive right to defer settlement for at least 12 months at the end of the reporting period. The amendment no longer refers to unconditional rights, since loans are rarely unconditional (for example, because the loan might contain covenants).
- The assessment determines whether a right exists, but it does not consider whether the entity will exercise the right. So, management's expectations do not affect classification.
- The right to defer only exists if the entity complies with any relevant conditions at the reporting date. A liability is classified as current if a condition is breached at or before the reporting date and a waiver is obtained after the reporting date. A loan is classified as non-current if a covenant is breached after the reporting date.
- 'Settlement' is defined as the extinguishment of a liability with cash, other economic resources or an entity's own equity instruments. There is an exception for convertible instruments that might be converted into equity, but only for those instruments where the conversion option is classified as an equity instrument as a separate component of a compound financial instrument.

### What is the impact and for whom?

The amendment changes the guidance for the classification of liabilities as current or non-current. It could affect the classification of liabilities, particularly for entities that previously considered management's intentions to determine classification and for some liabilities that can be converted into equity. All entities should reconsider their existing classification in the light of the amendment and determine whether any changes are required.

### When does it apply?

These amendments should be applied for annual periods beginning on or after 1 January 2022, retrospectively in accordance to IAS 8. Earlier application is permitted. If an entity applies those amendments for an earlier period, it should disclose that fact.

### Where do I get more details?

For more information, refer to the IAS 1 amendment (<https://www.ifrs.org/news-and-events/2020/01/iasb-clarifies-requirements-for-classifying-debt-as-current-or-non-current/>) or please contact

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# One-off cash compensation on collateralised derivatives due to the transition from EONIA to €STR: accounting impact on derivatives valuation and hedge accounting

## At a glance

In connection with reforms to EONIA, the rate of interest paid on the collateral on certain Euro-denominated collateralised derivatives is expected to be reduced. The effect on the fair value of outstanding derivatives will be compensated for by a one-off cash compensation payment. This In brief considers the accounting impact for both:

- the cash compensation: entities may book the compensation payment against the fair value of the derivative such that no net gain or loss will result; and
- affected hedge accounting relationships: the change will give rise to additional ineffectiveness, either at the time of the change or over time, depending on the particular facts and circumstances.

## What is the issue?

During the second half of 2019, the methodology for calculating EONIA was modified. EONIA was redefined as €STR plus a fixed spread of 8.5pbs for a transition period that will end on 31 December 2021. After that time, it is envisaged that EONIA will cease to be published and will transition to be €STR – although, at the time of writing (January 2020), there is still some uncertainty over the precise details of the transition.

The transition from EONIA to €STR is expected to result in a change to the interest rate paid on cash collateral held for certain Euro collateralised derivatives (from €STR plus a fixed spread of 8.5pbs to €STR flat) that is expected to be implemented in 2020<sup>1</sup>. When fair valuing collateralised derivatives, standard market practice is to use a discount rate that reflects the interest rate paid on the collateral. Accordingly, the change in the interest rate paid on the cash collateral will affect the fair value of the underlying derivatives. To compensate for this effect, it is expected that a one-off cash compensation payment between the parties will be made on the date of the change.

This In brief considers the accounting consequences of the above, in particular for:

- the one-off cash compensation; and
- the effect on pre-existing hedge accounting relationships that reference EONIA (in particular, when a derivative affected by the change is part of a hedging relationship).

## Example

Bank A holds a portfolio of derivatives with a central counterparty. The derivatives are ‘collateralised to market’ (that is, the collateral is accounted for separately from the derivatives)<sup>2</sup> and are subject to a cash collateral agreement. At 31 December 2019, the collateral is remunerated based on EONIA which, given the reforms in 2019, is set to be €STR plus a fixed spread of 8.5pbs. It is expected that, in mid-2020, the central counterparty will change the remuneration rate from EONIA (that is, €STR plus 8.5pbs) to €STR flat and apply cash compensation payments for derivatives outstanding at the date of the change. The cash compensation offsets the effect of the change in the collateral interest rate on the fair value of the derivatives.

## Does the one-off compensation payment relate to the derivative or the collateral? Will such compensation impact the fair value of the derivative as at earlier reporting dates?

The one-off cash compensation payment relates to the derivative, because the payment compensates the holder of the derivative for the change in the derivative’s fair value that arises as a consequence of the change in the interest rate on the collateral. As such, bank A may book the one-off cash compensation payment against the fair value of the derivative (rather than spread it forward). To the extent that the one-off payment

compensates for the change in fair value, this will result in no net gain or loss on the derivative at the time of the payment. Consistent with this approach, to the extent that the one-off payment will compensate for the fair value impact of the change in the collateral interest rate when it happens, we do not expect the one-off compensation payment to have an impact on the derivative’s IFRS 13 fair value as at reporting dates before the change is made (including 31 December 2019).

## If hedge accounting is applied, what impact (if any) will there be on the measurement of the hedged item, and will ineffectiveness arise?<sup>3</sup>

Since cash compensation is paid on the derivative hedging instrument but not on the hedged item, ineffectiveness will arise either at the time of the change or over time, depending on the particular facts and circumstances. The timing of the impact will depend on whether the discount rate used to calculate the change in fair value of the hedged item is changed, and it should be considered separately for cash flow and fair value hedges.

<sup>1</sup> For derivatives that are collateralised to market, this interest is referred to as ‘Price Alignment Interest’ or ‘PAI’; for derivatives that are settled to market, it is referred to as ‘Price Alignment Amount’ or ‘PAA’. See, for example, [LCH’s Circular No 4052 – Transition to €STR discounting in SwapClear](#).

<sup>2</sup> The first question below does not arise for ‘settled to market’ derivatives, since for such derivatives the collateral is not accounted for separately from the derivative.

<sup>3</sup> The guidance provided in this section applies to both ‘collateralised to market’ and ‘settled to market’ derivatives.

### **Cash flow hedges – Should the discount rate used to calculate the fair value of the hypothetical derivative be changed?**

This will depend on whether the hedge documentation identifies the discount rate as a particular risk-free rate that is impacted by the change.

For example, if the hedge documentation specified the discount rate as ‘the risk-free rate as measured by the rate paid on an equivalent collateralised derivative’, the discount rate used to calculate the fair value of the hypothetical derivative will need to be updated. The resulting gain or loss, which is not offset by any compensation, will cause one-off ineffectiveness at the time of the change that will need to be recognised in the income statement (subject to the normal ‘lower of’ test for a cash flow hedge).

Conversely, if the hedge documentation does not specify a particular discount rate (but, for example, references only ‘a risk-free rate’), an entity would need to exercise judgement in deciding whether to update the discount rate. Management should consider past practice in similar situations (for example, when the market transitioned from discounting collateralised derivatives using a rate based on LIBOR to one based on OIS). If the discount rate is not updated, the resulting ineffectiveness will arise and be recognised over time (subject to the normal ‘lower of’ test for a cash flow hedge).

### **Fair value hedges – Should the discount rate used to calculate the change in the fair value of the hedged item attributable to the hedged risk be changed?**

Similar considerations apply to fair value hedges, regarding following the hedge documentation or exercising judgement where the hedge documentation does not specify a particular discount rate. However, entities should bear in mind that, although the change in value of the hedged item is determined separately from the hedging instrument, the objective is to measure the change in the fair value of the hedged item attributable to the hedged risk using market participant assumptions.

#### **Where do I get more details?**

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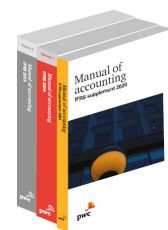
## Word on the Wharf

The Board met on [28-30 January 2020](#) at the IFRS Foundation's offices in London.

The topics, in order of discussion, were:

- Subsidiaries that are SMEs
- Business Combinations under Common Control
- Pensions Benefits that Depend on Asset Returns
- Implementation matters
- Disclosure Initiative-Targeted Standards-level Review of Disclosures
- Updating a Reference to the Conceptual Framework (Amendments to IFRS 3) Provisions
- Research programme update
- Rate-regulated Activities
- IBOR Reform and its Effects on Financial Reporting-Phase 2
- Amendments to IFRS 17 Insurance Contracts
- IFRS Taxonomy Update-Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7)

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