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Classification of Liabilities as Current or Non-current and its Deferral of Effective Date, Amendment to IAS 1
Issues Paper

Objective

1 The objective of this paper is to discuss and consider how agenda topic *Classification of debt with covenants as current or non-current* that were discussed in the IFRS Interpretations Committee (IFRS IC) meeting of December 2020 (see IFRS IC Agenda Paper AP2) will impact the final endorsement advice.

Description of the issue

2 In January 2020 the IASB issued *Classification of Liabilities as Current or Non-current*, which amended IAS 1 *Presentation of Financial Statements* and clarified how to classify debt and other financial liabilities as current or non-current in particular circumstances (IAS 1 amendments). The amendments were made to reconcile apparent contradictions between paragraph 69 (d) which required an 'unconditional right' to defer settlement and paragraph 73 which referred to an entity that 'expects, and has the discretion, to' refinance or roll over an obligation.

3 Paragraph 69 (d) of IAS 1 *Presentation of Financial Statements* requires an entity to classify a liability as current if the entity 'does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period'. Paragraph 73 requires an entity to classify a liability as non-current if the entity 'expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility'. In January 2020, the IASB amended aspects of this classification principle and related application requirements in paragraphs 73–76.

4 Paragraph 69 (d) of IAS 1 *Presentation of Financial Statements* is amended in relation to the right in the following way:

(a) 'unconditional' is deleted; and

(b) it was added 'at the end of the reporting period'.

5 The amendments specify that the conditions which exist at the end of the reporting period are those which will be used to determine if a right to defer settlement of a liability exists (paragraph 72A includes application guidance). Management expectations about events after the balance sheet date, for example on whether a covenant will be breached, or whether early settlement will take place, are not relevant.

6 The amendments could result in companies reclassifying some liabilities from current to non-current, and vice versa; this could affect a company's loan covenants.

7 Following the amendments, the IFRS IC were informed that stakeholders could find it difficult to determine whether it has 'the right to defer settlement' when a long-term

liability is subject to a condition (for example, a debt covenant) and the borrower's compliance with the condition is tested at dates after the end of the reporting period.

8 The IASB Staff considered three cases to determine whether it classifies a loan as current or non-current at the end of the reporting period (31 December 20X1).

Case 1

9 An entity has a loan which is repayable in five years (i.e at 31 December 20X6) - this condition applies to all cases below. The loan requires a working capital ratio above 1.0 at each 31 December, 31 March, 30 June and 30 September. The loan becomes repayable on demand if this ratio is not met at any of these testing dates. The entity's working capital ratio at 31 December 20X1 is 0.9 but the entity obtains a waiver before the reporting date with respect to the breach at that date. The waiver is for three months. Compliance with the covenant on the other testing dates continues to be required. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).

Case 2

10 Instead of the condition described in Case 1, the loan requires a working capital ratio above 1.0 at each 31 March (i.e. the ratio is tested only once a year at 31 March). The loan becomes repayable on demand if the ratio is not met at any testing date. The entity's working capital ratio at 31 December 20X1 is 0.9. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2.

Case 3

11 Instead of the condition described in Case 1, the loan requires a working capital ratio above 1.0 at 31 December 20X1 and above 1.1 at 30 June 20X2 (and at each 30 June thereafter). The loan becomes repayable on demand if the ratio is not met at any of these testing dates.

12 The entity's working capital ratio at 31 December 20X1 is 1.05. The entity expects the working capital ratio to be above 1.1 at 30 June 20X2.

IASB Staff analysis

Case 1

13 The IASB Staff notes that the entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition - a working capital ratio above 1.0 on 31 March, 30 June, 30 September and 31 December 20X2. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9.

14 the IASB Staff notes that the entity obtains a waiver from the lender but the waiver is for only three months after the reporting period. Paragraph 75 of IAS 1 states that 'an entity classifies the liability as noncurrent if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period…'. Accordingly, the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

Case 2

15 The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March 20X2.

16 The IASB Staff observes that paragraph 72A of IAS 1 addresses circumstances in which compliance with a specified condition is tested at a date after the end of the reporting period. That paragraph states that 'the entity must comply with the conditions at the end of the reporting period even if the lender does not test

compliance until a later date'. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9. Therefore, the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

Case 3

17 The IASB Staff observed that the entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with two specified conditions—a working capital ratio above 1.0 at 31 December 20X1 and a working capital ratio above 1.1 at 30 June 20X2.

18 The IASB Staff notes that paragraph 72A of IAS 1 states that 'if the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date'. The entity has a working capital ratio of 1.05 at 31 December 20X1.

19 Therefore, the entity complies with the condition tested at that date (a working capital ratio above 1.0) but does not comply with the condition that will be tested at 30 June 20X2 (a working capital ratio above 1.1). Consequently, the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

IASB Staff recommendation

20 The IASB Staff recommends that the IFRS IC does not add a standard-setting project to the work plan. Instead, it recommends publishing a tentative agenda decision that outlines how an entity accounts for the fact patterns described in the paper applying IFRS Standards.

IFRS IC Discussion

21 The IFRS IC members considered the Amendments as being useful to decrease the diversity in practice when classifying liabilities as current or noncurrent and the examples helpful to discuss the practical application of the Amendments in particular paragraph 72A. The IFRS IC members confirmed the analysis in the staff paper when applying the wording of the Amendments.

22 At the meeting few IFRS IC members raised concerns on the analysis of the staff related to the issues specifically with regards to paragraph BC48E (see paragraph 35 and 36 of the IFRS IC Agenda Paper AP2). IASB Board members explained BC48E relates to a very specific situation which is cumulative performance measures. BC48D explains the financial statement position. It was concluded that the wording of the standard is properly applied to the examples. Examples provided in the IASB Staff Paper only had balance sheet ratios as a covenant, discussions might come when examples with cumulative financial performance ratios would exist.

23 The IASB Board members present made clear that they wanted to focus on the reporting date and have a simple approach when classifying liabilities as current or noncurrent with the Amendments. Some IFRS IC members and observers expressed the view that the outcome especially for example three might be not intuitive and change over time. The IASB Board members present explained that no issues with forecasting and the probability should have impact on the classification of the liabilities. The simplicity was intended.

24 IFRS IC members considered it useful to proactively discuss the issues and to wait for feedback to decide about a way going forward. One mentioned that there is still time to adjust the covenants in the contracts.

Tentative decision of the IFRIS IC

25 In all three fact patterns described in this agenda decision, the IFRIS IC concluded that the entity is required to classify the loan as current because the entity does not have the right at the end of the reporting period (31 December 20X1) to defer settlement of the loan for at least twelve months after the reporting period.

26 In reaching its conclusion, the IFRS IC noted that the entity's expectation that it will meet the condition tested after the reporting period does not affect its assessment of the criterion in paragraph 69(d) of IAS 1. Applying paragraphs 69(d) and 72A of IAS 1, the entity's right to defer settlement of a liability for at least twelve months after the reporting period must exist at the end of the reporting period.

27 The IFRS IC concluded that the principles and requirements in IFRS Standards provide an adequate basis for the entity to determine how to classify the loan as current or non-current in the three fact patterns described in the agenda decision. Consequently, the IFRS IC [decided] not to add a standard-setting project to the work plan.

EFRAG Secretariat analysis

28 The EFRAG Secretariat agrees with the IASB analysis and recommendation not to add a standard-setting project to the work plan but to publish a tentative agenda decision as it could assist in reducing potential diversity in future.

29 The Secretariat agree with the technical analysis and conclusions for the 3 cases under consideration. However, as expressed in EFRAG's response to the IFRS Due Process Handbook, the EFRAG Secretariat do not believe that agenda decisions should be used to provide guidance on the accounting of very specific transactions for but rather explain the principles contained in the Standard. The IASB could consider developing more illustrative examples explaining these principles.

Questions for EFRAG TEG

30 Do you have any comments to the IFRIC decision? Do you think that it is necessary to raise concern about the IFRIC decision?

31 Does EFRAG TEG think that the issued draft endorsement advice should change following the discussions in the IFRS IC meeting of December 2020? If yes, how?