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

Objective

1 The objective of this session is to inform EFRAG TEG about the IASB proposed next steps with regards to the *Classification of Debt with Covenants as Current or Non-current* project.

Background

2 The amendments were issued because of an apparent contradiction between IAS 1 paragraph 69 (d) and paragraph 73. 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'.

3 The IASB adjusted paragraph 69 (d) and deleted the word "unconditional" and added that the right must exist at the end of the reporting period. Paragraph 72A was added to further specify the principle in paragraph 69(d) and paragraph 73 was amended. Some other following paragraphs were amended as well.

4 The ED was issued in 2015. The project was discussed in several IASB meetings but paused for a certain period while finalising the work on the framework. EFRAG TEG members can find the ED here and the final amendments in the following link. When comparing the ED and the Final Amendments mainly paragraph 72A was added (which further specify paragraph 69 (d)) and paragraph 73 was changed into a more principle based approach.

5 At its April 2016 meeting, the IASB decided that the remaining redeliberation's of the comments received would be held back until after the IASB has redeliberated the definitions of assets and liabilities in the Conceptual Framework exposure draft.

6 Amendments to IAS 1 were issued in January 2020, effective for annual reporting periods beginning on or after 1 January 2022. The Amendments improve existing requirements and could result in companies reclassifying some liabilities from current to non-current, and vice versa; this could affect a company's loan covenants.

7 In response to the covid-19 pandemic, the IASB provided entities with more time to implement any classification changes resulting from the Amendments by deferring the effective date by one year to annual reporting periods beginning on or after 1 January 2023.

8 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.

9 In December 2020 the IFRS IC provided additional insights into how the amendments would apply in different circumstances. A Tentative Agenda Decision (TAD) analysed three fact patterns.[1] The IFRS IC concluded in all three examples to classify the liabilities as current[2] and not to add the issue on its agenda. The consultation period has been open for comments until 15 February 2021.

10 EFRAG TEG discussed the *impact of TAD* that were discussed in the IFRS IC meeting of December 2020 on the Final Endorsement Advice and considered the comments received in response to EFRAG's Invitation to Comment on its Draft Endorsement Advice in its meeting on January 2021.

11 Additionally, EFRAG TEG discussed the *comments received* by the IFRS IC consultation which were going to be presented in the April IFRS IC discussion in its meeting on March 2021.

12 In its April 2021 meeting, the IFRS IC confirmed its agreement with the technical analysis and conclusions in the TAD. Nonetheless, before finalising the agenda decision, the IFRS IC decided to report to the IASB Board:

(a) the technical analysis and conclusions on the matter; and

(b) respondents' comments on the outcomes and potential consequences of applying the amendments, highlighting those that might provide information the IASB did not consider when developing the amendments.

IASB Staff proposed next steps

13 At its June 2021 meeting, the IASB Staff will present two papers (paper 12B and 12C) with:

(a) the background to the amendments and a summary of the IFRS IC discussions;

(b) a report with the technical analysis and conclusions on the matter; and

(c) a summary of feedback on the outcomes and potential consequences of applying the amendments, together with our analysis of that feedback.

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[1] Case 1 - Waiver: The loan is repayable in five years and includes a covenant that requires a working capital ratio above 1.0 at each end of a quarter. 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 Dec 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: The fact pattern is the same as Example 1 except: the covenant requires a working capital ratio above 1.0 at each 31 March (ratio is tested only once a year at 31 March). 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: The fact pattern is the same as Example 1 except: Instead of the condition described in Case 1, the covenant 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 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.

[2] The IFRS IC considered that paragraph 72A of IAS 1 should apply for all those cases and 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'.*

14 The IASB should tentatively decide about:

(a) whether the right to defer settlement for at least twelve months is subject to an entity complying with conditions after the reporting period, then those conditions do not affect whether the right to defer settlement exists at the end of the reporting period for the purposes of classifying a liability as current or non-current;

(b) for non-current liabilities subject to conditions, require an entity to disclose information about certain conditions (e.g. whether and how the entity expects to comply with the conditions);

(c) require that an entity presents separately, in its statement of financial position, 'non-current liabilities subject to conditions';

(d) clarify that an entity does not have a right to defer settlement at the reporting date when the related liability could become repayable within twelve month; and

(e) defer the effective date of the amendments to no earlier than 1 January 2024.

15 In order to take a decision, the IASB staff presents a summary of comments in line with the one presented in its April 2021 IFRS IC meeting and present a staff analysis.

16 The IASB staff acknowledges that the IASB when developing the amendments, specifically decided that an entity's circumstances at the reporting date would determine whether the entity classifies a liability as current or non-current and in general:

(a) the objective of conditions tested after the reporting date is to protect the lender's interests and that, for the condition to be effective in doing so, the protection must be in place continuously; and

(b) the right to defer settlement is implicitly conditional on continuous compliance with the conditions specified by the lender, even if those conditions are tested only on a specified date or dates.

17 However, the feedback from the TAD provided information about conditions that are not meant to provide protection to the lender by being 'in place continuously' and do not specifically consider:

(a) the seasonality of an entity's business; and

(b) the entity's future performance.

18 The IASB staff acknowledges respondents' concerns about the potential consequences and challenges of applying the amendments. However, they consider that those concerns could be mitigated by:

(a) explaining the reasons an entity classifies a liability as current and its expectation that the conditions will be satisfied in the future; and

(b) a broader understanding of the requirements that would develop once the amendments are applied.

19 They have considered those potential consequences and challenges in exploring possible standard-setting as it was previously requested by some of the IFRS IC TAD respondents.

20 The IASB staff has explored two standard setting approaches and highlights the challenges related to that (see June 2021 AP12C par. 42-80). The approaches explored are:

(a) ***Approach A - Retain the requirements in the amendments:*** the IASB retains the general classification requirements in the amendments, but:

(i) provide an exception for seasonal businesses; and

(ii) clarify how an entity assesses compliance with particular conditions.

(b) ***Approach B - Disclose information about conditionality***: the only conditions the entity is contractually required to comply with as of or before the reporting date would affect classification. However, an entity would be required to disclose whether it complies with conditions tested within twelve months of the reporting date based on its circumstances at that date and present related liabilities separately in the statement of financial position.

21 The IASB conducted some initial outreach with users of financial statements to obtain a more complete picture of stakeholder views on the application of the amendments as described in the TAD. The IASB met mainly with representatives from credit-rating agencies and asked for their views on the outcomes of applying the amendments in the fact patterns described in the TAD.

Approach A - Retain the requirements in the amendments

22 This approach would retain the requirement in paragraphs 72A of IAS 1. This approach builds on the underlying principle of the amendments that classification is based on whether the entity complies with conditions based on its financial position, financial performance and circumstances as of the reporting date.

23 An entity with a seasonal business might have negotiated conditions that specifically reflect its required financial position and performance at a specific point in its operating cycle and applying the requirements in paragraph 72A of IAS 1 in these circumstances might not provide useful information.

24 In case of applying this approach, the IASB should provide an exception for entities with a seasonal business. It would also aim to address questions about how an entity applies the amendments to cumulative financial performance conditions and non-financial conditions. This could be challenging because:

(a) determining whether a business is ‘seasonal’ would require judgement;

(b) the alternative test for conditions reflecting seasonality would be based on an entity’s financial position at a date before the reporting date, and would therefore be different from the assessment of compliance with other conditions;

(c) the approach could result in outcomes perceived as not providing useful information for conditions reflecting future performance; and

(d) some may consider the requirements for assessing compliance with cumulative financial performance conditions and non-financial conditions to be inappropriate for reasons similar to those stated for conditions reflecting future performance.

25 Finally, with this approach it would be difficult to develop exceptions for conditions reflecting seasonality and future performance while retaining the principles underlying the amendments. At the same time, a model based on management’s expectations would be a significant departure from the classification principle in paragraph 69(d) of IAS 1 (both before and after the amendments). Such an approach was also opposed as the basis for classification by the investors and analysts consulted in the IASB initial outreach.

Approach B - Disclose information about conditionality

26 This approach would retain the assessment of future conditions required by paragraph 72A of IAS 1 but, rather than the outcome of the assessment determining classification, an entity would instead provide that information in the notes to the financial statements together with other information relevant for an understanding of the conditions.

27 Classification as current or non-current would be based on assessing whether an entity complies with conditions contractually required to be tested as of or before the reporting date.

28 This approach could result in non-current classification in situations in which:

(a) the entity expects to fail to comply with future conditions; or

(b) it has failed to comply with conditions after the reporting date (but before financial statements are authorised for issue).

29 When applying this approach, an entity would not take into account whether, at the reporting date, it complies with future conditions. However, this could be addressed in one of two way:

(a) require separate presentation of 'non-current liabilities subject to conditions in the statement of financial position; or

(b) require entities to provide information about liabilities with conditions in the notes to the financial statements.

30 The advantages of applying this approach are:

(a) enhance the information an entity provides about the conditionality associated with its right to defer settlement while avoiding retaining classification requirements that could be complex;

(b) retain the principles in IAS 1 that classification reflects the circumstances at the reporting date; and

(c) be simple and easy to understand, while still providing information about future conditions and related risks through presentation and disclosure.

31 The IASB staff recommends ***amending IAS 1*** in line with approach B as it is described in paragraph 14 of this paper and deferring the effective date of the amendments by at least one year so that they apply to annual reporting periods beginning no earlier than on or after 1 January 2024.

Questions for EFRAG TEG

32 Does EFRAG TEG agree with the recommendations to amend the requirements in IAS 1 with respect to:

(a) the classification of liabilities subject to conditions and disclosure of information about conditions presented in paragraph 14;

(b) the separate presentation of these liabilities as presented in paragraph 14; and

(c) whether an entity has a right to defer settlement when that right is not subject to conditions with which an entity must comply as presented in paragraph 14 ?

33 Does EFRAG TEG agree with the recommendation to defer the effective date of the amendments by at least one year to annual reporting periods beginning no earlier than on or after 1 January 2024?