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

Objective

1 The objective of this session is to inform EFRAG Board:

(a) about the feedback that the IASB has received after the issuance of the Amendments to IAS 1;

(b) the IASB proposed next steps with regards to the *Classification of Debt with Covenants as Current or Non-current;* and to consider the consequences on the endorsement advice

Background

The initial Amendments

2 In January 2020 amendments to IAS 1 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 Board 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 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 from 1 January 2022 by one year to annual reporting periods beginning on or after 1 January 2023.

Recent IFRS IC discussions

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.

10 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. The feedback received during the consultation confirmed the technical analysis but criticised the outcome of the amendments. 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 next steps

11 At its June 2021 meeting, the IASB Staff presented 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'.*

12 The IASB was requested to 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 months; and

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

13 The IASB staff acknowledged 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.

14 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.

15 The IASB acknowledged 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.

16 The IASB discussed in its June meeting two standard setting approaches including the challenges related to that (see June 2021 AP12C par. 42-80). The approaches discussed 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.

17 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.

18 The IASB **tentatively decided to apply Approach B** mainly because a definition of seasonal business seems to be difficult.

19 The IASB tentatively decided to amend IAS 1 so that:

(a) it specifies that if the right to defer settlement for at least 12 months is subject to an entity complying with conditions after the reporting period, then those conditions would not affect whether the right to defer settlement exists at the end of the reporting period (the reporting date) for the purposes of classifying a liability as current or non-current; and

(b) for non-current liabilities subject to conditions, an entity is required to disclose information about:

(i) the conditions (for example, the nature of and date by which the entity must comply with the condition);

(ii) whether the entity would comply with the conditions based on its circumstances at the reporting date; and

(iii) whether and how the entity expects to comply with the conditions by the date on which they are contractually required to be tested.

20 The IASB decided about presentation of such liabilities. The IASB tentatively decided to amend IAS 1 to require that an entity present separately in its statement of financial position 'non-current liabilities subject to conditions in the next 12 months'. This line item would include liabilities classified as non-current for which the right to defer settlement for at least 12 months is subject to the entity complying with conditions after the reporting date.

21 The IASB tentatively decided to amend IAS 1 to clarify that an entity does not have a right to defer settlement at the reporting date when the related liability could become repayable within 12 months:

(a) at the discretion of the counterparty or a third party (for example, when a loan is callable by the lender at any time without cause); or

(b) if an uncertain future event occurs (or does not occur) and the event's occurrence (or non-occurrence) is unaffected by the entity's future actions (for example, when the liability is a financial guarantee or insurance contract liability).

22 The advantages of applying this approach instead of approach A 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.

23 The IASB confirmed 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.

Endorsement Advice on the initial Amendment

24 EFRAG consulted on the Draft Endorsement Advice in 2020 and extended the comment period until beginning of 2021. At the current stage EFRAG TEG did not recommend finalising the Endorsement Advice based on the feedback received. EFRAG TEG was in favour to wait for the IASB's next steps. The European Commission has been informed by the EFRAG Secretariat regarding the issue.

Recent EFRAG discussions

25 EFRAG TEG discussed the *impact of TAD* (IFRS IC meeting of December 2020) on EFRAG's 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. 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.

26 In its June 2021 meeting EFRAG TEG discussed Option A and B based on the IASB staff papers. EFRAG TEG members welcomed the initiative of the IASB to further refine the approach taken in the initial Amendments to solve the concerns emerged from the recent IFRIC consultation. They were also generally in favour of Option B. The Amendments were initially considered as "non-significant", i.e., subject to approval by written procedure at the EFRAG Board level and a special focus was put on the project on the basis of the concerns emerging form the IFRIC consultation. EFRAG Secretariat considers that, given the direction that the IASB project is taking, a written approval procedure can be considered appropriate for the next steps.

Questions for EFRAG Board

27 Does EFRAG Board have any comments or questions?

28 Does EFRAG Board agree to discuss the draft and final endorsement advice by written procedure?