Issue 159/Updated July 2020

IFRS Developments

Amendments to classification of liabilities as current or non-current

What you need to know

- The IASB's amendments clarify the criteria for determining whether to classify a liability as current or non-current.
- 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.
- The amendments clarify the situations that are considered settlement of a liability.
- The new guidance will be effective for annual periods starting on or after 1 January 2023.

Highlights

On 23 January 2020, the International Accounting Standards Board (IASB or the Board) issued amendments to paragraphs 69 to 76 of IAS 1 *Presentation of Financial Statements* (the amendments) to specify the requirements for classifying liabilities as current or non-current.

Background

The amendments were originally driven by a request to the Board to clarify how the classification principle in paragraph 69 interacts with the requirements of paragraph 73 when an entity expects to refinance or roll over an obligation under an existing loan facility.

The amendments were first proposed as part of Exposure Draft (ED) *Annual Improvements to IFRSs 2010-2012 cycle*, published in May 2012, and were subsquently re-exposed in isolation in the ED *Classification of Liabilities (Proposed Amendments to IAS 1)* in February 2015. The final amendments go beyond the proposals in the ED of 2015, which were restricted to the above-mentioned issue. More specifically, the final amendments have implications for the requirements related to covenant breaches.

Building a better working world

The amendments

The amendments clarify:

- What is meant by a right to defer settlement
- That a right to defer must exist at the end of the reporting period
- That classification is unaffected by the likelihood that an entity will exercise its deferral right
- That only if an embedded derivative in a convertible liability is itself an equity instrument would the terms of a liability not impact its classification

Right to defer settlement

The Board addressed the original request for clarification by removing 'unconditional' in the fourth criterion in paragraph 69, which states that a liability is current if an entity 'does not have an unconditional right to defer settlement of the liability for at least twelve months'. The Board explained that a right to defer settlement is rarely unconditional, as such rights often are conditional on compliance with covenants. Therefore, the Board decided that if an entity's right to defer settlement of a liability is subject to the entity complying with specified conditions, the entity has a right to defer settlement of the liability at the end of the reporting period if it complies with those conditions at that date.

How we see it

Under current practice, 'an unconditional right' is interpreted to have a similar meaning to the meaning of 'right' in the amended standard. As such, a right conditional on compliance with covenants in future periods is considered 'unconditional' if the entity is in compliance with those conditions at the end of the reporting period. Therefore, we do not expect that this clarification will significantly impact current practice.

Existence at the end of the reporting period

The amendments also clarify amendments that the requirement for the right to exist at the end of the reporting period applies regardless of whether the lender tests for compliance at that date or at a later date.

The Board considered whether to provide guidance on how management would assess an entity's compliance at the end of the reporting date if a condition related to cumulative performance in a period, for instance, a profit measure, and the period extended beyond the reporting period. The Board agreed that, in such cases, an entity would have to estimate future performance beyond the end of the reporting period, or, alternatively, adjust the benchmark to the performance period up to the end of the reporting period, to make them comparable. Only if comparable, will they be relevant in determining whether the entity would be in compliance with the applicable conditions. However, acknowledging that different facts and circumstances will apply in each case, the Board decided not to specify a method to apply when adjusting for comparability.

How we see it

Current practice may be somewhat mixed with respect to whether compliance with future covenant tests are considered for the purpose of classification at the end of the reporting period. Therefore, it is possible that this amendment may impact the practice of some entities.

Management expectations

The Board also considered whether events after the reporting period, such as breaches of covenant or early repayments by the entity, would affect the classification of the liability.

IAS 1.75A has been added to clarify that the *'Classification of a liability is unaffected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting period'*.

Therefore, any expectations about events after the reporting period (and prior to the authorisation of financial statements) do not impact the assessment made at the end of the reporting period as to the classification of the liability. Thus, although management may intend to settle a financial liability shortly after the end of the reporting period, as long it has a right to defer settlement for at least twelve months, the liability is classified as non-current. This applies even if settlement has occurred when the financial statements are authorised for issuance. It should be noted, however, that there may be disclosure requirements in accordance with IAS 10 *Events after the reporting period* relating to the change in circumstances of the liability, such as a settlement of the liability.

How we see it

Generally, we do not expect the clarifications regarding management expectations and intentions to have a significant impact on practice, since most entities consider the right as at the end of the reporting date as determining the classification, under current practice. However, we are aware that some entities have considered management expectations and intentions when determining whether a liability is current or non-current.

Meaning of the term 'settlement'

The Board added two new paragraphs (paragraphs 76A and 76B) to IAS 1 to clarify what is meant by 'settlement' of a liability. The Board concluded that it was important to link the settlement of the liability with the outflow of resources of the entity. As such, paragraph 76A states:

'For the purpose of classifying a liability as current or non-current, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of:

a) cash or other economic resources—for example, goods or services; or

b) the entity's own equity instruments, unless paragraph 76B applies.'

Many liabilities are settled by the transfer of cash from the entity. Some liabilities are settled by the transfer of resources other than cash, such as goods or services, or an entity's own equity instruments.

As clarified in paragraph 76A, settlement by way of own equity instruments is considered settlement for the purpose of classification of liabilities as current or non-current, with one exception. The exception is prescribed in paragraph 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*.' Thus, in cases where a conversion option is classified 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. Only if the conversion option itself is classified as an equity instrument would settlement by way of own equity instruments be disregarded when determining whether the liability is current or non-current.

Unchanged from the current standard, a rollover of a borrowing is considered the extension of an existing liability and is therefore not considered to represent 'settlement'.

How we see it

With respect to the impact of classification of conversion options as equity or liability, it is possible that the amendment may have an impact on practice for some entities. This is because the current standard does not clarify whether classification of the conversion option as equity is required for settlement by transfer of own equity instruments to be disregarded for the purpose of classifying a liability as current or non-current.

Transition and effective date

The amendments to IAS 1 are required to be applied for annual periods beginning on or after 1 January 2023. The amendments must be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted.

How we see it

Many entities will find themselves already in compliance with the amendments. However, entities need to consider whether some of the amendments may impact their current practice. Entities need to carefully consider whether there are any aspects of the amendments that suggest that terms of their existing loan agreements should be reconsidered. In this context, it is important to highlight that the amendments must be applied retrospectively.

EYG No. 000391-20Gbl

ED None