EFRAG

European Financial Reporting Advisory Group

**Draft Comment Letter**

**Comments should be submitted by 3 June 2015 to [commentletters@efrag.org](mailto:commentletters@efrag.org)**

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

37. Sitzung IFRS-FA am 10.04.2015
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[Date]

Dear Sir/Madam,

**Re: ED/2015/1 *Classification of Liabilities - Proposed amendments to IAS 1***

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2015/1 *Classification of Liabilities - Proposed amendments to IAS 1*, issued by the IASB on 10 February 2015 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

Our detailed comments and responses to the questions in the ED are set out in the Appendix.

To summarise, EFRAG agrees with the IASB's objective to clarify the requirements in IAS 1 *Presentation of Financial Statements* on classification of liabilities and remove some inconsistencies in the terms used in the Standard. In EFRAG's view, the proposals in the ED are likely to result in greater consistency in applying the principles in IAS 1 and therefore in relevant financial information.

However, to avoid further diversity in practice, EFRAG recommends that additional guidance is provided in situations where the rights to defer settlement of a liability are subject to conditions that occur and are assessed after the reporting period. EFRAG also believes that, to avoid unintended outcomes, the IASB should clarify the guidance in paragraph 69(d) for liabilities that can be settled, at the option of the counterparty, in an entity's own instruments.

Finally, EFRAG suggests that the IASB further explores whether current guidance always provides the most relevant information when rights to defer settlement are not 'substantive' as of the reporting period. This could be achieved, for instance, as part of the ongoing research that the IASB is conducting in its *Performance Reporting* project.

If you would like to discuss our comments further, please do not hesitate to contact Giorgio Acunzo, Alejandro Saenz, Hocine Kebli or me.

Yours faithfully,

Roger Marshall
**Acting President of the EFRAG Board**

## APPENDIX

**Question 1 − Classification based on the entity's rights at the end of the reporting period**

The IASB proposes clarifying that the classification of liabilities as either current or non-current should be based on the entity's rights at the end of the reporting period. To make that clear, the IASB proposes:

a) replacing "discretion" in paragraph 73 of the Standard with "right" to align it with the requirements of paragraph 69(d) of the Standard;

b) making it explicit in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and

c) deleting "unconditional" from paragraph 69(d) of the Standard so that 'an unconditional right' is replaced by 'a right'.

Do you agree with the proposed amendments? Why or why not?

### Notes to constituents

1 *The IASB received a request to clarify the criteria for the classification of a liability as either current or non-current. The issue raised was how having an* unconditional right to defer settlement *(in paragraph 69(d) of IAS 1* Presentation of Financial Statements*) would be reconciled with having the* discretion to refinance or roll over an obligation *(in paragraph 73 of IAS 1) as two bases for classifying a liability as non-current.*

2 *To clarify the requirements, the IASB is proposing to:*

(a) *Align the requirements in paragraphs 69(d) and 73 by deleting the reference to* unconditional *rights (to defer settlement) and to* discretion *and replacing them with a reference to* rights *in both paragraphs; and*

(b) *Make it explicit that only rights in existence at the reporting date should affect the classification of a liability.*

3 *The IASB further proposes that guidance in IAS 1 should be reorganised so that the similar examples currently displayed in paragraphs 72 to 76 of IAS 1 are grouped together.*

### EFRAG's response

**EFRAG supports the proposals in the ED as they clarify the existing classification principles in IAS 1 by removing inconsistencies in the terms used and are likely to result in greater consistency in applying the principles in IAS 1. However, to avoid further diversity in practice, EFRAG recommends that additional guidance is provided in situations when a right to defer settlement is subject to conditions that are assessed after the reporting period.**

4 EFRAG agrees with the IASB's objective to clarify how the requirements in IAS 1 on classification of liabilities apply by removing the inconsistent terms in paragraphs 69(d) and 73 of IAS 1 *Presentation of Financial Statements*, which both define bases for the classification of a liability as non-current.

5 In EFRAG's view, the proposed Amendments are clarifying, rather than changing, the existing requirements contained in IAS 1 and are likely to result in more

consistent application of these principles by making it explicit that only rights in place at the reporting date should affect the classification of a liability.

6 However, EFRAG believes that the difficulties in applying the classification requirements do not only relate to the inconsistent use of terms in paragraph 69(d) and 73 of IAS 1. EFRAG believes that uncertainty exists in the application of the classification requirements when an entity has a right to defer the settlement of a liability that is subject to conditions.

7 Paragraph BC 4 in the basis for conclusions of the ED states that, when a right is subject to a condition, it is whether the entity complies with that condition as at the end of the reporting period that determines whether the right should affect the classification. EFRAG believes that, in some cases, it might be difficult to assess whether an entity complies with conditions at the reporting date. Examples include situations described in the following paragraph.

8 An entity has a loan with a contractual maturity of less than 12 months and a roll over option to extend the maturity for more than 12 months subject to respecting a financial covenant (e.g. loan to value below 90%) and, either:

(a) The covenant is calculated with reference to the financial position at a date after the end of the reporting period (31 March) but the entity determines at the reporting date (31 December) that it would breach the covenant had the test been performed with reference to the financial data at the reporting period; or

(b) The covenant is calculated with reference to the financial position as of the reporting period but based on the annual audited financial statements that are only available at a later date (31 March). When approved, the financial statements show that the covenant is breached.

9 In the above fact patterns, one view could be that the entity has not yet breached any covenant at the end of the reporting period, because the breach is only determined at a later date. Another view would be that the circumstances indicate that, already at the reporting date, the entity has substantially failed to comply with the conditions surrounding its right to defer settlement.

10 Therefore, EFRAG believes that it would be helpful to address these situations, as additional application examples, within the guidance in paragraphs 72R and 73R. In EFRAG's view, additional application guidance on the issues described above would help entities understand how that judgement should be exercised, and would therefore result in greater consistency in the application of the requirements.

*Other considerations about the 'existence of a right'*

11 Paragraph BC 16 in the basis for conclusions of the ED clarifies that management's intentions and expectations should not affect the classifications of liabilities. EFRAG observes that this may result, in some instances, in classification of liabilities that is based on rights that are not substantive, and that the entity will never be in a position to exercise. This is the case, for instance, when a right to defer settlement is subject to conditions that are tested only after the reported period, but the terms of the conditions are such that it is inevitable that the entity would fail to comply.

12 EFRAG believes that the IASB should further explore these aspects and assess whether the current guidance always provide the most relevant information. This could be achieved, for instance, as part of the ongoing research that the IASB is conducting in its *Performance Reporting* project.

**Question 2 − Linking settlement with the outflow of resources**

13 The IASB proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding “by the transfer to the counterparty of cash, equity instruments, other assets or services” to paragraph 69 of the Standard.

14 Do you agree with that proposal? Why or why not?

### Notes to constituents

*15 The IASB proposes to clarify the meaning of the term* settlement *for the purposes of the classification of liabilities by adding that* settlement *refers to the transfer to the counterparty of cash, equity instruments, other assets or services.*

### EFRAG’s response

**EFRAG agrees with the proposals. However, we believe that the drafting of these proposals should be improved in order to avoid unintended outcomes.**

16 EFRAG agrees with the proposed amendments as they make explicit the link between the settlement of the liability and the transfer of resources and clarify that, for instance, a rollover of a borrowing does not constitute settlement and would not result in the liability being classified as current.

17 However, EFRAG would like to draw the IASB’s attention to the possible unintended effects consequences of the interactions between:

(a) current guidance in paragraph 69(d) of IAS 1, which stipulates that ‘*terms of a liability that could, at the option of the counterparty, results in its settlement by the issue of equity instruments do not affect the classification*”; and

(b) the proposed additional wording in paragraph 69 that states that ‘*for the purposes of classification, settlement of liability refers to the transfer to the counterparty of cash, equity instruments* (emphasis added)*, other assets or services*”.

18 EFRAG believes that it is unclear how the two requirements would interact for instance in a situation where a liability can be settled, at the option of the lender, either in cash in three years or by transferring a variable number of equity instruments within twelve months. Two views seem possible:

(a) the liability could be classified as non-current if the option to settle in shares is disregarded for classification purposes, as required in paragraph 69(d), which is not modified by the proposed ED; or

(b) The liability could be regarded as current as the entity does not have a ‘right to defer settlement’ for more than twelve months if the holder exercises the option.

19 Furthermore, EFRAG notes that paragraphs BC38G and BC38H in the basis for conclusions of IAS 1 state that:

(a) the IASB had previously concluded that issuing equity instruments does not result in an outflow of cash or other assets and therefore is not useful in assessing the liquidity and the solvency position of an entity; and

(b) classifying the liability on the basis of the requirement to transfer cash or other assets rather than on settlement better reflects the liquidity and solvency position of an entity.

20 Accordingly, EFRAG believes that the drafting of the proposals should be improved to clarify the above.

**Question 3 − Transition arrangements**

The IASB proposes that the proposed amendments should be applied retrospectively.

Do you agree with that proposal? Why or why not?

**EFRAG's response**

**EFRAG agrees with the IASB's proposals to apply these amendments to IAS 1 retrospectively.**

21 EFRAG supports retrospective application of the proposed amendments in the ED in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, as it results in financial information that is comparable.

22 EFRAG observes, in that respect, that paragraph 46 of IAS 1 already requires entities to reclassify comparative information, when making changes in presentation.