IASB ISSUES AMENDMENTS TO IAS 1 - CLASSIFICATION OF LIABILITIES AS CURRENT OR NON-CURRENT

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BACKGROUND

The International Accounting Standards Board ('IASB') issued *Amendments to IAS 1 – Classification of Liabilities as Current or Non-current* in January 2020. The amendments had originally been issued as an exposure draft in February 2015. The IASB considered the feedback received in December 2015 but in April 2016 it decided to delay the issuance of the amendments pending completion of the IASB's project on the Conceptual Framework, which included the definition of a 'liability'. The Board's work on the amendments to IAS 1 restarted in September 2018 and were completed in the third quarter of 2019.

The IASB noted that these amendments are intended to be clarifications of the requirements of IFRS, rather than fundamental changes. Diversity in practice had emerged in a number of areas due to perceived inconsistencies in IAS 1, where certain paragraphs appeared to contradict one another. Therefore, depending on how IAS 1 has been interpreted in the past, the clarification of the requirements may result in significant changes to how entities classify liabilities.

STATUS
Final

EFFECTIVE DATE
Periods beginning on or after 1 January 2022. Early application is permitted. Retrospective application required.

ACCOUNTING IMPACT
May change the classification of certain liabilities from current to non-current or vice versa.

SCOPE OF AMENDMENTS

Not all entities present current and non-current liabilities in their statements of financial position (e.g. many financial institutions such as banks and insurance companies). However, the distinction between current and non-current liabilities is crucial for many entities, in particular for financial liabilities. This is because it affects key metrics such as current ratios, and may impact covenants and other measures of liquidity.

Determining whether a liability is presented as current or non-current is often focused on liabilities that meet the definition of financial instruments, such as bank loans, bonds, etc. It is important to note that the revised requirements in IAS 1 apply to the classification of all liabilities, which would include, but are not limited to:

- Financial liabilities within the scope of IFRS 9 (e.g. bank loans, derivative financial liabilities, accounts payable);
- Provisions within the scope of IAS 37 (e.g. provisions, lawsuits, certain warranty provisions);
- Current income tax liabilities within the scope of IAS 12. Note that deferred tax liabilities are required to be classified as non-current in all instances (IAS 1.56);
- Lease liabilities within the scope of IFRS 16;
- Contract liabilities within the scope of IFRS 15 (e.g. liabilities that will be satisfied in the future by the delivery of goods and/or services); and
- Cash-settled share-based payment liabilities within the scope of IFRS 2.

SUMMARY OF EFFECTS

The amendments to IAS 1 are broad, and may impact entities in many different ways, some of which may be unexpected. It is important that entities carry out an analysis of the impact of the revised requirements on the recognised liabilities in their statements of financial position.

CONDITION FOR CURRENT CLASSIFICATION: RIGHT TO DEFER SETTLEMENT

The amendments modify one of the criteria in IAS 1 that results in a liability being classified as current. Any of the criteria being satisfied results in the liability being classified as current (i.e. it is an 'or' test). The first three criteria are unchanged, and require an entity to classify a liability as current when (IAS 1.69):

(a) It expects to settle the liability in its normal operating cycle;

(b) It holds the liability primarily for the purpose of trading;

(c) The liability is due to be settled within twelve months after the reporting date.

IAS 1.69(d) was amended such that if an entity does not have 'the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period' then it must be classified as current. Therefore, as amended, a liability is required to be classified as a non-current liability as long as an entity has the right to defer its settlement for at least twelve months, regardless of the entity's intention.

In practical terms, this means that a liability is classified as non-current (assuming that it does not satisfy criteria (a)-(c) of IAS 1.69) even if, for example, the entity:

- Fully intends to settle liability within the next twelve months by exercising a prepayment option; or
- Has settled the liability after its reporting date but before the related financial statements have been issued. This would require disclosure as a non-adjusting subsequent event in accordance with IAS 10, but it does not impact the classification of the liability as non-current.

This amendment emphasises that the classification of a liability is not dependent on an entity's intentions; it is dependent on the rights (or control) that the entity has in relation to the timing of the settlement of the liability.

DEFINITION OF 'SETTLEMENT'

The amendments to IAS 1 clarify what is meant by 'settlement', since the classification criteria in IAS 1.69 are contingent on an assessment of the entity's rights relating to the 'settlement' of liabilities. The amendments add new paragraphs 76A and 76B, which clarify that settlement means a transfer to the counterparty that results in the extinguishment of the liability. Such a 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.

Paragraph 76B clarifies that 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 the option is classified as an equity instrument separately from the liability as an equity component of a compound financial instrument, by applying IAS 32, *Financial Instruments: Presentation*. 76B is essentially a condition where, if specified criteria are met for the way in which a liability may be settled, that settlement mechanism is disregarded for purposes of classifying a liability.

The requirements of 76B are illustrated below.

Example 1 – Convertible debt with conversion feature classified as equity

Entity A issues a CU ('currency unit') 100 note payable with an 'American style' conversion option, exercisable at the option of the holder at any time over the life of the note. Interest is payable annually in arrears. If exercised, the conversion feature will result in the principal amount of the note being converted into 10 common shares of Entity A together with cash settlement of any accrued but unpaid interest. Otherwise, the note payable is repayable, plus interest, in 5 years. CU is the functional currency of Entity A.

Analysis – the note is a compound financial instrument containing a financial liability (the note payable plus interest) and an equity instrument (the conversion feature). The conversion feature is an equity instrument because there is no obligation to pay cash and the conversion feature will result in a fixed amount of cash (the note) being exchanged for a fixed number of shares (i.e. the 'fixed for fixed' test in IAS 32 is satisfied).

The components of the compound financial instrument are classified as follows:

COMPONENT	CLASSIFICATION	RATIONALE
Financial liability – note payable (principal amount)	Non-current liability	Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, does not affect the note's classification as current or non-current because the conversion feature is classified as an equity instrument. The principal and accrued interest are not due for 5 years, therefore, Entity A has the right to defer settlement for at least twelve months (IAS 1.69(d)).
Financial liability – accrued but unpaid interest	Current liability	Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months (IAS 1.69(d)).
Equity component – conversion feature	N/A – equity	Equity is not classified as current or non-current.

Example 2 – Convertible debt with conversion feature classified as derivative financial liability

Example 2 is identical to Example 1, except for the section <u>*underlined and in italics.*</u>

Entity A issues a CU ('currency unit') 100 note payable with an 'American style' conversion option, exercisable at the option of the holder at any time over the life of the note. Interest is payable annually in arrears. If exercised, the conversion feature will result in the principal amount of the note being converted into 10 common shares of Entity A together with cash settlement of any accrued but unpaid interest. Otherwise, the note payable is repayable, plus interest, in 5 years. CU is <u>*not*</u> the functional currency of Entity A; <u>*its functional currency is FU ('foreign units')*</u>.

Analysis – the note is a hybrid financial instrument containing a financial liability (the note payable plus interest) and a derivative financial liability (the conversion feature). The conversion feature is a derivative financial liability because, despite there being no obligation to pay cash, the conversion feature does not satisfy the 'fixed for fixed' criteria in IAS 32, as the note payable is denominated in a currency other than Entity A's functional currency. Therefore, the amount of cash that will be required to settle the liability on conversion is not represented by a fixed amount of cash expressed in Entity A's functional currency. That is to say, the note that may be settled by the exercising of the conversion feature is fixed in terms of CU, but not FU, the functional currency of Entity A.

The components of the hybrid financial instrument are classified as follows:

COMPONENT	CLASSIFICATION	RATIONALE
Financial liability – note payable (principal amount)	Current liability	Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, does affect the note's classification as current or non-current because the conversion feature is not classified as an equity instrument. As the option may be exercised at any time, the entity does not have the right to defer settlement of the liability for at least twelve months (IAS 1.69(d)).
Financial liability – accrued but unpaid interest	Current liability	Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months (IAS 1.69(d)).
Derivative financial liability – conversion feature	Current liability	The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months (IAS 1.69(d)).

Summary

The amendments to IAS 1 clarify that 'settlement' of a liability has a broader meaning than the transfer of cash or other financial instruments. It includes the transfer of goods or services, and in some cases, equity instruments.

A small adjustment to the fact pattern between Example 1 and 2 results in significantly different outcomes. In Example 1, the host financial liability (the note payable) is classified as non-current, and the conversion feature is not classified because it is an equity instrument. In Example 2, a very similar instrument has both of its components classified as current financial liabilities.

The introduction of the new paragraphs 76A and 76B may therefore significantly impact entities that issue compound financial instruments.

ASSESSING COMPLIANCE WITH CONDITIONS THAT AFFECT CLASSIFICATION

Many liabilities have conditions that affect whether an entity has the right to defer settlement of the liability for at least twelve months (IAS 1.69(d)). These may include covenants included in the contractual terms of a financial liability, such as a bank loan.

The amendments to IAS 1 add paragraph 72A, which clarifies that an 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. If the right to defer settlement is subject to the entity complying with specific conditions (e.g. covenants), 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, regardless of when the entity is required to test that compliance.

The implications of these revised requirements are illustrated below:

Example 3 – Covenants to be tested based on issued, audited financial statements

Entity Z has a 31 December 20x3 year-end. Entity Z has a long-term bank loan that will be repayable in 5 years. However, the bank has the right to demand repayment immediately if Entity Z does not maintain a specified debt to equity ratio as at each calendar year-end. The contractual terms of the bank loan stipulate that compliance with this covenant will be assessed based on the audited financial statements that Entity Z's management must provide to the bank by 31 March of the following calendar year.

Analysis – Entity Z must classify its bank loan as current or non-current. IAS 1.72A requires Entity Z to comply with the conditions at the end of the reporting period (31 December 20x3) in order for the bank loan to be classified as a non-current liability. This requirement exists regardless of the fact that compliance with the covenant will not be assessed until 31 March of the following year. Therefore, Entity Z calculates its debt to equity ratio, and classifies the bank loan as a current or non-current liability in its 31 December 20x3 financial statements based on the outcome of this calculation. If Entity Z satisfied the conditions of the covenant, then the loan is classified as non-current.

If Entity Z does not satisfy the conditions of the covenant, then the loan is classified as current because the bank has the right to demand repayment immediately (i.e. entity Z would not have the right to defer settlement for at least twelve months – IAS 1.69(d)).

It should be noted that this outcome is consistent with BDO's view of the requirements of IAS 1 prior to these amendments, therefore, in BDO's view, this should not result in a change in practice.

Example 4 – Right to defer settlement assessed at an interim period

Entity Y has a 31 December 20x3 year-end, and is currently preparing its 30 June 20x3 interim financial statements in accordance with IAS 34, *Interim Financial Reporting*. Entity Y has a long-term bank loan that will be repayable in 5 years with a loan covenant specifying that the bank has the right to demand repayment immediately if Entity Y does not maintain a specified debt to equity ratio as at each calendar year-end (i.e. as at 31 December). No conditions contractually apply as at 30 June (i.e. compliance is not assessed as at this date). The contractual terms of the bank loan stipulate that compliance with this covenant as at 31 December will be assessed based on the audited financial statements that Entity Y's management must provide the bank by 31 March of the following calendar year.

Analysis – as at 30 June 20x3, Entity Y's right to defer settlement of the bank loan depends on it satisfying its contractual covenant as at 31 December 20x3, which is 6 months in the future. Despite there being no requirement to comply with the test as at 30 June 20x3, IAS 1.72A states that a right to defer settlement must exist as at the end of the reporting period (i.e. 30 June 20x3), and this right exists only if the entity complies with those conditions at the end of the reporting period, regardless of when the lender tests for compliance at that date.

CONCLUSION

The amendments to IAS 1 are effective for annual reporting periods beginning on or after 1 January 2022, with retrospective restatement required. Therefore, in an entity's 31 December 2022 financial statements, the effects of these amendments must be reflected in the 31 December 2021 comparative period. Therefore, entities must assess the impact of the amendments quickly to ensure the effects are understood. In some cases, entities may wish to renegotiate certain agreements, covenants and arrangements if the amendments could result in the reclassification of certain liabilities from non-current to current.

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