IFRS

STAFF PAPER

July 2019

IASB® meeting

Project	**Classification of Liabilities as Current or Non-current (Amendments to IAS 1)**
Paper topic	Liabilities with equity-settlement features

CONTACT(S) Joan Brown jbrown@ifrs.org +44 (0)20 7246 6916

Paper overview

1. The Exposure Draft *Classification of Liabilities* (Exposure Draft) proposed amendments to paragraphs 69-76 of IAS 1 *Presentation of Financial Statements*. Those paragraphs specify requirements for classifying liabilities as current or non-current.

2. At its meeting in March 2019, the Board:

   (a) tentatively decided to clarify the requirements for classifying liabilities with equity-settlement features, that is liabilities an entity will or may settle by transferring its own equity instruments to the counterparty; and

   (b) asked the staff to perform focused consultation to obtain a better understanding of the practical consequences of the clarifications.

3. This paper discusses the feedback from the consultation.

Background—tentative decisions and consultation performed

4. Paragraph 69(d) of IAS 1 requires an entity to classify a liability as current if the entity does not have a right to defer settlement of the liability for at least twelve months after the reporting period. The Exposure Draft proposed to add a clarification that settlement 'refers to the transfer to the counterparty of cash, *equity instruments*, other assets or services that results in the extinguishment of the liability'. [emphasis added]

5. Paragraph 69(d) of IAS 1 already refers to equity instruments. It specifies some circumstances in which a transfer of equity instruments would *not* be treated as settlement:

> … Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification'.

The Board added this reference as an annual improvement in 2009.

6. Respondents to the Exposure Draft asked the Board to clarify the interaction between the two references to equity instruments.

7. In a staff paper discussed by the Board in March 2019, the staff concluded that when the Board added the statement about counterparty conversion options in 2009, it had intended the statement to apply narrowly, that is only when a convertible bond or similar financial instrument includes a holder conversion option that meets the definition of an equity instrument and is recognised separately as an equity component of a compound financial instrument.[1]

[1] March 2019 IASB meeting Agenda Paper 29A *Classification of Liabilities as Current or Non-Current—Liabilities with equity-settlement features*

Example 1—Holder option recognised separately as an equity instrument

An entity issues a convertible bond that matures five years after the reporting period. The bond comprises a contractual obligation to deliver cash to the holder of the bond (a liability) and an option granted to the holder to convert the bond into a fixed number of the entity's ordinary shares at any time before maturity (an equity instrument).

Applying paragraph 28 of IAS 32 *Financial Instruments: Presentation*, the entity recognises the convertible bond as a compound financial instrument, recognising the liability and equity components separately allocating the initial carrying amount between them.

Applying paragraph 69(d) of IAS 1, the terms of the equity instrument do not affect the classification of the liability as current or non-current. The entity otherwise has a right to defer settlement of the liability for five years so classifies it as **non-current**.

8. The staff concluded that for other instruments—that is, if an equity-settlement obligation is classified as a *liability or part of a liability*—the terms of the obligation would affect the classification of that liability as current or non-current. Such instruments would include bonds with holder conversion options that are not separated from the host liability (Example 2) and instruments that mandate settlement in a variable number of equity instruments (Example 3).

Example 2—Holder option recognised as part of host liability

The facts are the same as those in Example 1 except that the holder has an option to convert the bond into as many of the entity's ordinary shares as are equal in value to CU100[2].

Because the holder option obliges the entity to deliver a variable number of its own equity instruments, the option does not meet the definition of an equity instrument. The bond is not a compound financial instrument—it is recognised as a liability in its entirety.

The terms of the conversion option included within the liability would affect the classification of the liability as current or non-current. Conversion could occur at any time so the liability would be classified as **current**.

[2] In this paper, monetary amounts are denominated in 'currency units' (CU).

Example 3—Equity-settled obligation classified as a liability

An entity issues a financial instrument that obliges it to transfer to the counterparty six months after the reporting date as many of its ordinary shares as are equal in value to CU100.

Because this instrument obliges the entity to deliver a variable number of its equity instruments, it does not meet the definition of an equity instrument so is classified as a liability. Settlement will be required within 12 months so the liability would be classified as **current**.

9. The staff conclusion in the March 2019 staff paper was influenced by a statement in the Basis for Conclusions accompanying IAS 1, which discusses the scope of the reference added in 2009:

> BC38P The Board discussed the comments received in response to its exposure draft of proposed *Improvements to IFRSs* published in 2007 and noted that some respondents were concerned that the proposal in the exposure draft would apply to all liabilities, not just those that are components of convertible instruments as originally contemplated in the exposure draft. Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended the proposed wording to clarify that the amendment applies only to the classification of a liability that can, at the option of the counterparty, be settled by the issue of the entity's equity instruments.

10. At its meeting in March 2019, the Board tentatively decided to clarify the IAS 1 requirements in line with the staff conclusions. But it also asked the staff to perform focused consultation to obtain a better understanding of the practical consequences of the clarifications.

11. The staff consulted members of the IFRS Interpretations Committee (Committee), asking those members with relevant experience for their views on how the clarifications could affect practice.

Feedback

12. Four Committee members from accounting firms responded. They responded informally in a personal capacity, not representing official positions of their firms. However, three had consulted colleagues from across their networks and so were able to include information about jurisdictional differences.

Significant and widespread practical implications

13. The Committee members reported that the clarifications would have significant and widespread practical implications, whose nature and extent would vary from one jurisdiction to another. Specifically:

    (a) in some jurisdictions, where there is diversity in practice at present, the clarifications would reduce the diversity. At present in those jurisdictions:

        (i) some entities apply IAS 1 as the Board has tentatively decided to clarify it. They ignore a holder conversion option only if it is separately classified as an equity component of a compound financial instrument. Consistently with the Board's tentative decisions, those entities classify the instrument illustrated in Example 1 as *non-current*, and the instruments illustrated in Examples 2 and 3 as *current*.

        (ii) other entities instead ignore any holder conversion option, irrespective of its classification as equity or a liability (possibly applying the wording in paragraph 69(d) of IAS 1 without reference to the Basis for Conclusions). They classify the bonds illustrated in both Example 1 and Example 2 as *non-current*.

        (iii) there may be a practice, albeit more limited, of also classifying as *non-current* any liabilities that must be settled in equity instruments (such as the instrument illustrated in Example 3) or that the *issuer* has an option to settle in equity instruments. Such a practice might have evolved as a result of confusion caused by the lack of clarity in IAS 1 and particularly by a statement in the Basis for Conclusions accompanying the 2009 amendments. Paragraph BC38O reports a Board conclusion that classifying a liability 'on the bases of the requirements to transfer cash or other assets rather than on settlement better reflects the liquidity and solvency position of the entity'.

In jurisdictions where there is diversity in practice, the proposed clarifications would reduce the diversity, requiring a change in practice for some entities with conversion options classified as liabilities. Those entities would reclassify some liabilities from non-current to current.

(b) in some jurisdictions, there is at present no significant diversity in practice, but practice is inconsistent with the Board's tentative decisions. Entities disregard any holder conversion option, however classified. In other words, they classify the bonds illustrated in both Example 1 and Example 2 as *non-current*. The proposed clarifications would require a change in practice for all entities with conversion options classified as liabilities. Those entities would reclassify some liabilities from non-current to current.

(c) in some jurisdictions, entities tend not to issue financial instruments with equity settlement features classified as liabilities. In those jurisdictions the clarifications would have little or no effect on practice.

14. One Committee member said that because the clarifications would result in some entities reclassifying debt from non-current to current, applying the clarifications could jeopardise those entities' compliance with loan covenants. The Committee member stressed the need for enough time between any amendments being finalised and becoming effective for affected entities to re-negotiate covenants.

Need to address embedded derivatives

15. Two Committee members highlighted a gap in the Board's tentative decisions for holder conversion options. They noted that, although the decisions covered conversion options recognised separately as equity instruments (Example 1) and conversion options not separated from their host liabilities (Example 2), they did not

explicitly cover conversion options recognised separately as embedded derivatives. These members said that holder conversion options might be recognised separately as embedded derivatives if, for example, the shares were denominated in a foreign currency (Example 4) or the number of shares issued depended on a triggering event and the conversion option was judged to be not closely related to the debt host.

> **Example 4—Holder option recognised separately as an embedded derivative**
>
> The facts are the same as those in Example 1 except the bond is denominated in a foreign currency.
>
> An entity issues a foreign currency convertible bond that matures five years after the reporting period. The bond comprises a contractual obligation to deliver foreign currency cash to the holder of the bond (a liability) and an option granted to the holder to convert the bond into a fixed number of the entity's ordinary shares at any time before maturity.
>
> The conversion option does not meet the definition of an equity instrument because it obliges the entity to exchange a variable amount of cash (in its functional currency) for a fixed number of its own equity instruments (ie it fails the 'fixed-for-fixed' criteria in IAS 32). The conversion option is, however, an embedded derivative which section 4.3 of IFRS 9 requires to be recognised separately from the host liability (unless the entity designates the entire instrument under the fair value option).

16. One committee member noted that an example like Example 4 had been discussed in 2014 by the IFRS Discussion Group of the Canadian Accounting Standards Board.[3] The group had considered different views on whether the paragraph 69(d) reference to counterparty conversion options applied to that example. Most group members thought the paragraph 69(d) reference should apply because conversion would not involve a cash outflow. Applying this view to Example 4, the conversion option would not affect the classification of the host liability, which would be classified as *non-current*.

[3] See AcASB IFRS Discussion Group, Report of December 9, 2014 meeting.

Apparent lack of underlying principle

17. Two Committee members suggested the proposed clarifications appeared to lack an underlying principle. One suggested that:

    (a) if the objective is to provide information about the timing of a possible outflow of cash or other economic resources, any obligation to issue the entity's own equity instruments should be ignored. In other words, the instruments in Examples 1–3 should all be classified as *non-current*.

    (b) if instead the objective is to portray the duration of a liability, the possible timing of *any* obligation to issue the entity's own equity instruments should be considered, irrespective of how the equity settlement feature is classified. In other words, the instruments in Examples 1–3 should all be classified as *current*.

18. Those Committee members suggested that, without a clear principle, the proposed clarifications would not achieve the clarity the Board was aiming for and so would not eliminate diversity in practice. Instead they would entrench an existing inconsistency and perpetuate confusion.

Mixed opinions on the tentative decisions

19. Two Committee members expressed explicit support for clarifying the IAS 1 requirements for classifying liabilities with equity-settlement features.

20. However, Committee members reported mixed opinions amongst their colleagues on the Board's tentative decisions on *how* to clarify the requirements. They reported that:

    (a) some support the Board's tentative decisions, because they either agree with the outcomes or accept that the clarifications would reduce diversity in practice. One Committee member noted that entities are required to disclose a substantial amount of information about complex financial instruments so could readily explain why particular liabilities are classified as current or non-current.

(b) some suggested the Board should consider deleting from paragraph 69(d) of IAS 1 the exception for holder conversion options classified as equity components of compound financial instruments. If conversion of a liability was always treated as settlement of the liability (irrespective of the classification of the conversion option), there would be greater consistency in the treatment of different instruments and no risk of the diversity in practice.

(c) some disagree with treating an issue of the entity's own equity instruments as settlement of a liability for the purpose of classifying the liability as current or non-current. They think a liability should be classified as current only if it could require an outflow of cash or other economic resources within 12 months (consistently with the 'outflow of economic resources' principle described in paragraph 17(a)). Classifying other liabilities as current could provide a misleading picture of an entity's liquidity and would not provide useful information about the entity's use of assets in the next operating cycle.

21. One Committee member referred to his firm's response to the Exposure Draft. The firm had recommended a more fundamental review of the liability presentation requirements in IAS 1. It had suggested the Board consider whether the current/non-current distinction remains relevant now that entities disclose information about liquidity risk and contract maturities to comply with other IFRS Standards, such as IFRS 7 *Financial Instruments: Disclosures*. The Committee member suggested this more fundamental review could be included in the Board's project on Primary Financial Statements.

One recommendation for re-exposure

22. One Committee member suggested that the Board should consider re-exposing for comment any proposals to amend the requirements for liabilities with equity-settlement features. The Committee member thought re-exposure would be warranted because the nature and extent of comments on the Exposure Draft demonstrated the concepts are generally not well understood.

Staff responses to aspects of the feedback

23. In this section, the staff respond to suggestions that the Board needs to:

    (a) identify the principle underlying the proposed clarifications and ensure the clarifications address all holder options—including those separately recognised as embedded derivatives (paragraphs 24–32); and

    (b) allow enough time between any amendments being finalised and becoming effective for affected entities to re-negotiate covenants (paragraph 33).

Underlying principle and its application to embedded derivatives

24. The staff think the existing IAS 1 requirements, as the Board has tentatively decided to clarify them, could reflect either of two different underlying principles. Depending on which principle they reflect, the requirements would apply differently to the embedded derivative example (Example 4) described in paragraph 15.

Principle A—outflow of economic resources

25. One underlying principle (Principle A) could be that:

    (a) a liability is classified as current only if it could require within 12 months an outflow of cash or other economic resources (the 'outflow of economic resources' principle described in paragraph 17(a)); but

    (b) a transfer of the entity's own equity instruments is treated as an outflow of economic resources if the obligation to make that transfer is classified as a liability. A liability is defined as an obligation to transfer an economic resource.[4] So, the reason for classifying the obligation as a liability would also be the reason for treating the transfer as an outflow of economic resources.

[4] The full definition of a liability, in paragraph 4.2 of the *Conceptual Framework* for Financial Reporting is 'a present obligation of the entity to transfer an economic resource as a result of past events'. The definition in use in 2009 similarly defined a liability as an obligation 'the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.

For example, IAS 32 requires an entity to classify as a liability an obligation to transfer a variable number of its own shares whose value equals a fixed amount. Paragraph BC10(a) of the Basis for Conclusions accompanying IAS 32 explains that such an obligation is a liability because the entity is using its own shares as a currency. A currency is an economic resource.

26. Applying this principle, all settlement outcomes would be considered in classifying a liability except those separately recognised as *equity instruments*. A conversion option separately recognised as an *embedded derivative* would affect the classification of the host liability. In Example 4, the host liability would be classified as *current*.

Principle B—include only the obligations within the liability being classified

27. An alternative underlying principle (Principle B) could be that the classification of a liability as current or non-current reflects the duration of the liability (the ‘duration of liability’ principle described in paragraph 17(b)) but *considering only the obligations that make up the liability being classified*—that is, ignoring obligations recognised as separate liabilities or equity instruments. If the liability being classified includes an obligation to transfer an entity’s own equity instruments (Examples 2 and 3), the possible timing of that transfer would be considered in classifying the liability. In contrast, if the liability being classified does not include an obligation to transfer the entity’s own equity instruments because that obligation has been recognised separately (Example 1), the entity would not consider the timing of that transfer in classifying the liability.

28. Applying this principle, a conversion option separately recognised as an embedded derivative would not affect the classification of the host liability. In Example 4, the host liability would be classified as *non-current*.

Comparing the principles

29. Principle B is consistent with some other IFRS requirements for financial instruments:

(a) IAS 1 requirements for classifying liabilities as current or non-current are based on the entity's ability to defer settlement of the liability. Other IFRS Standards use the term 'settlement' to encompass extinguishment by the issue of the entity's own equity instruments. For example, IAS 32 requirements for classifying financial instruments with characteristics of equity have a section entitled 'Settlement in the entity's own equity instruments'. Furthermore, the versions of the *Conceptual Framework* in issue at the time IAS 1 and IAS 32 requirements were developed included 'conversion of the obligation to equity' within a list of ways in which settlement of a liability may occur.[5]

(b) where IFRS Standards require a financial instrument to be divided into components, each component is generally accounted for separately according to its nature as if it were a stand-alone instrument. Consistently with this approach, a liability should be classified as current or non-current considering only the obligations recognised within that liability—not those recognised as separate liabilities or equity instruments.

30. However, a principle that an entity classifies a liability as current or non-current by considering only the obligations that are recognised as part of that liability could have unintended knock-on consequences. If applied more generally, it could affect the way entities view settlement obligations other than conversion options (including cash settlement obligations). For example, an entity might issue a liability that is repayable in 10 years unless a specified triggering event occurs, which gives the holder an option to demand immediate repayment. In some circumstances, the counterparty's option might meet the criteria for separate recognition as an embedded derivative. If

5 In paragraph 62 of the *Framework for the Preparation and Presentation of Financial Statements*, issued in 1989, and carried forward into paragraph 4.17 of the *Conceptual Framework for Financial Reporting* issued in 2010.

so, the issuer would not consider the possibility that it may be obliged to repay the liability early when it classifies the host liability as current or non-current.

31. The staff think it is unlikely the Board intended the outcomes described in paragraph 30 when it added the reference to conversion options to paragraph 69(d) as an annual improvement in 2009. So if the Board were to develop requirements consistent with Principle B (that is, considering only the obligations making up the obligation being classified), it could be viewed as changing, rather than clarifying, the existing requirements.

32. For these reasons, the staff think that, if the Board clarifies the requirements for liabilities with equity settlement features, it should not do so applying Principle B. Instead, the Board should clarify that the statement in paragraph 69(d) of IAS 1 applies only to a counterparty conversion option recognised separately from the liability as an *equity* component of a compound financial instrument. Any other equity-settlement feature—including an embedded derivative recognised separately from the host liability—does affect the classification of the liability as current or non-current. This clarification would be consistent with Principle A described in paragraph 25.

Effects on covenants

33. Concerns about reclassifications triggering breaches of covenants are also reported in paragraph 8(d) of Agenda Paper 29B *Classification of Liabilities as Current or Non-current—Transition and early application*. The staff think that the Board could address these concerns by giving entities enough time to renegotiate covenants before implementing the proposed amendments. We would therefore consider the concerns when developing recommendations on the effective date of the amendments (to be discussed at a future meeting).

Staff conclusions

34. The staff conclude that the consultation feedback provides further evidence that:

    (a) existing IAS 1 requirements for classifying liabilities with equity-settlement features are not sufficiently clear to prevent diversity in practice; and

    (b) the Exposure Draft proposal to clarify the meaning of 'settlement' could raise questions about some existing practices without providing clear answers. So further clarification is needed.

35. As explained in paragraph 32, the staff think the Board should clarify the requirements by clarifying that the statement in paragraph 69(d) of IAS 1 applies only to a counterparty conversion option recognised separately from the liability as an *equity* component of a compound financial instrument. Any other equity-settlement feature—including an embedded derivative recognised separately from the host liability—does affect the classification of the liability as current or non-current.

36. Before the Board finalises the amendments to IAS 1, it will consider whether it needs to re-expose them in the light of changes to the original proposals. The staff do not think that the additional clarification described in paragraph 35 would itself create a need for re-exposure. It is not a fundamental change to the Exposure Draft proposals and would not have a fundamental effect on financial reporting. Furthermore, given the quantity and quality of information the Board has already obtained via its targeted consultation, the staff do not think the Board is likely to learn much more by re-exposing the proposals.

Staff recommendation and question for the Board

37. Paragraph 69(d) of IAS 1 states that terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification as current or non-current.

38. The staff recommend clarifying in IAS 1 that this statement applies only to a counterparty conversion option recognised separately from the liability as an equity component of a compound financial instrument. Otherwise, extinguishing a liability by transferring equity instruments to the counterparty constitutes settlement of the liability for the purpose of classifying it as current or non-current.

Question for the Board
Do you agree with the staff recommendation in paragraph 38?