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STAFF PAPER

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Project	**Classification of Liabilities as Current or Non-current**
Paper topic	Liabilities with equity-settlement features

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Overview of paper

Introduction

1. The Exposure Draft *Classification of Liabilities* published in February 2015 (Exposure Draft) proposed amendments to requirements in paragraphs 69-76 of IAS 1 *Presentation of Financial Statements*. Those requirements relate to classification of liabilities as current or non-current.

2. This paper discusses whether, and if so how, to revise the Exposure Draft proposals for liabilities with equity-settlement features—that is, liabilities the entity will or may settle by transferring its own equity instruments to the counterparty.

Exposure Draft proposals

3. 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 clarify 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'.

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Feedback

4. Respondents to the Exposure Draft raised two concerns about the including a reference to equity instruments in that sentence:

   (a) some respondents disagreed that issuing equity instruments should be viewed as 'settlement' of a liability for the purpose of classifying the liability as current or non-current;

   (b) many respondents asked for more clarification. In particular, they questioned how the proposed new reference to equity instruments would interact with a statement in IAS 1 that:

   > 69(d) … 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'.

   Some respondents suggested the proposed new reference is incompatible with that existing statement.

Staff conclusions and recommendations

5. The staff conclude that the Exposure Draft proposals are compatible with existing IAS 1 requirements:

   (a) the existing statement in paragraph 69(d) of IAS 1 applies only if 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 applying IAS 32 *Financial Instruments—Presentation*. The statement in paragraph 69(d) means that the terms of the equity component do not affect the classification of the liability component as current or non-current.

   (b) the proposed new reference to equity instruments applies to an obligation to transfer equity instruments that does not meet the definition of equity and so is classified as a *liability*. The proposed new reference means that the transfer of the entity's own equity instruments is regarded as settlement of that liability for the purpose of classifying it as current or non-current.

6. The staff recommend refinements to the Exposure Draft proposals to clarify both the existing IAS 1 requirements and the proposed amendments.

Structure of paper

7. This paper discusses:

   (a) existing IAS 1 requirements for classifying liabilities with equity-settlement features (paragraphs 8–17);

   (b) the Exposure Draft proposals (paragraphs 18–20);

   (c) the proposals of the US Financial Accounting Standards Board (FASB) (paragraphs 21–23); and

   (d) comments received on:

      (i) whether issuing equity instruments should ever be regarded as settlement of a liability for the purpose of classifying the liability as current or non-current (paragraphs 24–26); and

      (ii) how the proposed new reference to equity instruments interacts with the existing statement and how that interaction could be clarified (paragraphs 27–32).

Existing IAS 1 requirements for classifying liabilities with equity-settlement features

8. 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 a right to defer settlement of the liability for at least 12 months after the reporting period.

9. When it was first issued, IAS 1 was silent on whether converting a liability into equity would constitute 'settlement'. However, the *Framework for the Preparation and Presentation of Financial Statements* included 'conversion of the obligation to equity' within a list of examples of ways in which settlement of a liability may occur.[1] Furthermore, the definition of a financial liability in IAS 32 refers to contracts 'that will or may be settled in the entity's own equity instruments'.

10. By classifying liabilities as current or non-current on the basis of the timing of settlement (irrespective of the method of settlement), IAS 1 results in entities providing information about the duration of their liabilities.

11. In 2009, as part of its annual improvements process, the Board added a clarification relating to the classification of convertible financial instruments:[2]

> 69(d) … 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.

12. This requirement to disregard a counterparty conversion option would apply to a bond or similar instrument convertible by the holder into a fixed number of ordinary shares. Assuming the conversion option meets the definition of an equity instrument in paragraph 16 of IAS 32, paragraph 28 of IAS 32 requires the entity to account for a 'compound' financial instrument—with an equity component (the holder's right to convert the instrument into a fixed number of equity instruments of the issuer) and a liability component (the obligation to deliver cash), which are recognised separately.

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1 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.

2 *Improvements to IFRSs*, April 2009.

13. In those cases, the effect of paragraph 69(d) of IAS 1 is that the terms of the equity component do not affect the current/non-current classification of the liability component:

> **Example 1—Convertible bond accounted for as a compound financial instrument**
>
> An entity issues a convertible bond that matures five years after the reporting period. The bond comprises two components: a financial liability (a contractual obligation to deliver cash to the holder of the bond) and an equity instrument (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).
>
> Applying paragraph 28 of IAS 32, the entity recognises the two components of the bond separately, allocating the initial carrying amount between them.
>
> Applying paragraph 69(d) of IAS 1, the holder's option to convert the liability to equity instruments within 12 months does not affect the classification of the liability. The entity otherwise has a right to defer settlement for five years so classifies the liability component as a non-current liability.

14. IAS 1 does not state explicitly that the requirement to disregard a holder's conversion option applies *only* to options that meet the definition of equity instruments and are recognised separately from the liability. However, there is evidence that the requirement was intended to apply only to such options:

    (a) the Board added the requirement as part of its annual improvements process in response to a request from the International Financial Reporting Interpretations Committee (IFRIC). The request specifically referred to convertible financial instruments accounted for as compound financial instruments, with separate equity and liability components.

    (b) the IFRIC Agenda Decision (reproduced in the appendix to this paper) noted an argument that, because IAS 1 addresses the presentation of liabilities (not equity), the equity component of a compound financial instrument should be ignored in determining the presentation of the liability component. This rationale applies only if a conversion option meets the definition of an equity instrument and is accounted separately from the liability.

(c) paragraph BC38P in the Basis for Conclusions accompanying IAS 1 explains that:

> 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.

15. Thus, the staff conclude that the reference to equity instruments in IAS 1 applies only to conversion options classified as equity components of a compound financial instrument. If, instead, an entity's obligation to transfer its own equity instruments does not meet the definition of an equity instrument and so is classified as a liability, the general concepts described in paragraph 9 of this paper apply—the transfer of the instruments is a form of 'settlement' for the purposes of classifying the liability as current or non-current.

16. For example:

> **Example 2—Equity-settled obligation classified as a liability**
>
> An entity issues a financial instrument that obliges it to transfer to the counterparty as many of its ordinary shares as are equal in value to CU100[3] at the time of transfer.
>
> Because this instrument contains a contractual obligation to deliver a variable number of the entity's own equity instruments the entity classifies it as a liability applying paragraphs 11 and 16 of IAS 32.
>
> The entity classifies this instrument as a current liability if it will or may be required to deliver the shares to the holder within 12 months after the end of the reporting period.

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

17. Paragraph BC13 of the Basis for Conclusions accompanying IAS 32 explains the reasons for requiring classifying as liabilities some obligations to deliver equity instruments. It explains that 'it would be inappropriate to account for a contract as an equity instrument when an entity's own equity instruments are used as a currency …'. The view of the equity instruments as a currency also provides a basis for classifying an obligation to deliver those instruments within twelve months as a current liability—an obligation to deliver a currency within twelve months would be classified as a current liability.

Exposure Draft proposals

18. The Exposure Draft included a proposal to clarify the meaning of the term 'settlement'. It proposed to add to paragraph 69:

> For the purposes of classification as current or non-current, settlement of a liability refers to the transfer to the counterparty of cash, equity instruments, other assets or services that results in the extinguishment of the liability.

19. This sentence reinforces the objective underlying of the IAS 1 requirements as being to provide information about the duration of liabilities (irrespective of the method of settlement). It was proposed primarily to help clarify why rolling over a liability does not constitute settlement and that settlement of a performance obligation could involve a transfer of goods or services (not necessarily cash).[4] However, for completeness, the Board also included in the list transfers of equity instruments, noting that:

> BC14 The Board also considered the case of an equity-settled instrument, or the component of a financial instrument, that is classified as a liability in accordance with IFRS. The Board concluded that settlement for the purposes of classification of a liability as either current or non-current would also refer to the transfer of equity instruments to the counterparty of such a financial instrument.

[4] Exposure Draft Classification of Liabilities, February 2015, paragraphs BC12–BC13.

20. Because BC14 refers to equity-settled instruments or components of instruments that are classified as liabilities, the staff conclude that the Exposure Draft proposals are consistent with existing IAS 1 requirements:

    (a) the existing statement in paragraph 69(d) of IAS 1 applies only if 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 applying IAS 32. The statement in paragraph 69(d) means that the terms of the equity component do not affect the classification of the liability component as current or non-current.

    (b) the proposed new reference to equity instruments applies to an obligation to transfer equity instruments that does not meet the definition of equity and so is classified as a *liability*. (That obligation could be a holder conversion option or another type of obligation.) The proposed new reference means that the transfer of the entity's own equity instruments is regarded as settlement of such a liability for the purpose of classifying the liability as current or non-current.

FASB proposals

21. The US Financial Accounting Standards Board (FASB) is also updating its requirements for classification of liabilities as current or non-current. It is close to finalising a proposed Accounting Standards Update, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current versus Noncurrent)*.

22. The FASB proposals for classification of liabilities with equity-settlement features are different from the IASB proposals. In September 2017, the FASB tentatively decided that 'the issuance of equity instruments does not constitute settlement when determining whether debt should be classified as current or non-current'.

23. The rationale is that the issuance of equity securities does not require the use of current assets or the creation of other current liabilities (as defined in US GAAP). The effect of the FASB proposals would be that, for example, the classification of convertible debt would be determined on the basis of when the liability is

contractually due to be settled (that is, when there is a required use of current assets) rather than on the timing of the conversion of debt to equity. Thus the FASB proposals reflect a different objective for classification of a liability as current or non-current from that applied in IAS 1 (see paragraph 19).

Whether issuing equity instruments is settlement of a liability

Comments on Exposure Draft proposals

24. Some respondents disagreed that issuing equity instruments (converting a liability to equity) should ever be regarded as 'settlement' of a liability for the purpose of classifying it as current or non-current. They argued that:

    (a) the objective of identifying current assets and current liabilities is to provide information about the liquidity position of the entity;

    (b) consistent with this objective, a liability should be classified as current only if it could require an outflow of resources within twelve months of the reporting date; and

    (c) issuing an equity instrument does not require an outflow of resources.

25. Some of those respondents also referred to paragraphs BC38N–BC38O in the Basis for Conclusions accompanying IAS1:

> BC38N IAS 1 and the *Framework* state that information about the liquidity and solvency positions of an entity is useful to users. The terms 'liquidity' and 'solvency' are associated with the availability of cash to an entity. Issuing equity does not result in an outflow of cash or other assets of the entity.
>
> BC38O The Board concluded that classifying the liability on the basis of the requirements to transfer cash or other assets rather than on settlement better reflects the liquidity and solvency position of an entity, and therefore it decided to amend IAS 1 accordingly.

Staff analysis and conclusions

26. The staff conclude that the Board does not need to take further action in this project in response to these comments:

    (a) the respondents who disagreed with the Exposure Draft proposals are advocating a different classification objective from that underpinning the requirements of IAS 1. It is of note that paragraphs BC38N and BC38O were added to the Basis for Conclusions when the Board amended IAS 1 in 2009. These paragraphs need to be read with paragraph BC38P (see paragraph 14(c) of this paper), which makes it clear that the purpose of the amendments was not to change the overall approach for classification of liabilities—it was to specify requirements only for liabilities that are components of convertible instruments.

    (b) the purpose of this project is to clarify existing IAS 1 requirements, not fundamentally review the classification objective. Furthermore, the Board might find it difficult to reach decisions before it has more fully-formed proposals in its project on Financial Instruments with Characteristics of Equity.

Interaction between references to equity instruments

Comments on Exposure Draft proposals

27. Many respondents to the Exposure Draft—including IOSCO and all the large accounting firms and many of the standard-setters responding—questioned the interaction between the proposed new reference to settlement by the transfer of equity instruments and the existing statement in paragraph 69(d) that holder conversion options do not affect the classification of liabilities as current or non-current.

28. Some respondents specifically highlighted the difficulty they would have deciding which statement to apply to a liability that includes a holder option for conversion of the liability to a variable number of the entity's equity instruments (such that the whole instrument is classified as a liability, not as a compound instrument).

29. Respondents urged the Board to reconcile the two statements. Some respondents expressed views on how to reconcile them:

    (a) in line with the staff conclusions in paragraph 20 of this paper, some respondents suggested that:

        (i) the existing statement in paragraph 69(d) is intended (or could be specified) to apply only to compound financial instruments; whereas

        (ii) the proposed new reference may be intended (or could be specified) to apply to obligations to transfer equity instruments, including counterparty conversion options, that would be classified as a liability or part of a liability.

        One respondent noted this intention can be inferred from the bases for conclusions accompanying IAS 1 and the Exposure Draft but suggested it needs to be clarified in the Standard.

    (b) a few respondents thought the existing statement was intended (or should be specified) to refer to the entity's *own* equity instruments whereas the proposed new reference was intended (or should be specified) to refer to a *third party's* equity instruments that the entity holds as investments. Without suggesting an answer, other respondents asked the Board to clarify whether the proposed new reference was intended to apply to the entity's own equity instruments or those of another entity (or both).

    (c) a few respondents noted that the existing reference in paragraph 69(d) refers to the 'issue' of equity instruments, whereas the proposed new reference at the end of paragraph 69 refers to the 'transfer' of equity instruments. They asked if the existing reference is intended to apply only to liabilities that could be settled by *issuing new* shares, with the proposed new reference applying to liabilities that would be settled by *transferring previously issued* shares (that the entity might have to buy in the market).

    (d) a few respondents thought that the new reference may be intended to override the existing reference in paragraph 69(d) and so suggested deleting the existing reference.

Staff analysis and conclusion

Need to refine the proposals

30. The comments on the Exposure Draft proposals are evidence that the existing requirements and proposed additions are not clear enough. The staff think both could be clarified by:

    (a) stating more explicitly within IAS 1 the circumstances in which equity-settlement features affect the classification of a liability as current or non-current:

        (i) the existing statement in paragraph 69(d) of IAS 1 applies only if 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 applying IAS 32. The statement in paragraph 69(d) means that the terms of the equity component do not affect the classification of the liability component as current or non-current.

        (ii) the proposed new reference to equity instruments applies to an obligation to transfer equity instruments that does not meet the definition of equity and so is classified as a *liability*. (That obligation could be a holder conversion option or another type of obligation.) The proposed new reference means that the transfer of the entity's own equity instruments is regarded as settlement of that liability for the purpose of classifying it as current or non-current.

    (b) clarifying that both references are to the entity's *own* equity instruments; and

    (c) aligning the terminology—referring in both cases to the 'transfer to the counterparty' (not 'issue') of the entity's own equity instruments. The term transfer would apply to any means of delivering the entity's equity instruments the counterparty, including issuing new instruments.

Whether refinements would require re-exposure

31. The staff do not think that refining the proposals on equity-settlement features as described in paragraph 30 would create a need for re-exposure of the Exposure Draft. The refinements are not fundamental changes—they would clarify existing IAS 1 requirements and proposed amendments whose implications were discussed in the Basis for Conclusions accompanying the Exposure Draft. Furthermore, the proposals relating to equity-settlement features are only a small part of the overall amendments proposed to IAS 1.

32. However, the staff note that many respondents appear to have misunderstood the existing IAS 1 requirements and Exposure Draft proposals (both of which can be understood fully only by reading their accompanying bases for conclusions). This might be an indication that in practice some entities are not classifying liabilities with equity-settlement features in the way intended by IAS 1. Some further targeted consultation could give the Board additional information about the likely effects of the proposed amendments and further reassurance that the proposals are reasonable and workable.

Staff recommendations

33. The staff recommend that the Board refines the Exposure Draft proposals as described in paragraph 30 to clarify both the existing IAS 1 requirements and the proposed amendments.

Questions for the Board

Questions for the Board	
1	Do you agree that the Board should refine the Exposure Draft proposals as described in paragraph 30?
2	Would you like the staff to undertake any further targeted consultation on the refined proposals?

Appendix—Extract from November 2006 IFRIC *Update*

IFRIC Agenda Decisions

IAS 1 *Presentation of Financial Statements* – Whether the liability component of a convertible instrument should be classified as current or non-current.

The IFRIC was asked to consider a situation in which an entity issued convertible financial instruments that, in accordance with IAS 32 *Financial Instruments: Presentation*, were accounted for as two elements—an equity component (ie the holders' rights to convert the instruments into a fixed number of equity instruments of the issuer any time before the maturity date) and a liability component (ie the entity's obligation to deliver cash to holders at the maturity date, which was more than one year after the balance sheet date). The issue was whether the liability component should be presented as current or non-current on the face of the issuer's balance sheet.

The IFRIC observed that both IAS 1 *Presentation of Financial Statements* and the *Framework for the Preparation and Presentation of Financial Statements* state that information about the liquidity and solvency of an entity is useful to users. The IFRIC also noted that the definitions of liquidity and solvency refer to the availability of cash to the entity. On that basis, the IFRIC believed that the liability component should be classified as non-current.

On the other hand, the IFRIC noted that paragraph 60(d) of IAS 1 states that a liability should be classified as current if the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date. According to paragraph 62 of the *Framework*, conversion of an obligation into equity is considered as the settlement of a liability. In addition, according to the definition of a financial liability set out in paragraph 16 of IAS 32, a financial liability may be settled through the delivery of a variable number of the issuer's own equity instruments. Settlement of a liability is not confined to delivery of cash or other assets.

The IFRIC believed that the above IFRS requirements appeared to be in conflict. In addition, the IFRIC observed that practice, in determining whether the liability component was classified as current or non-current, focused on when the issuer was obliged to deliver cash or other assets.

The IFRIC received a comment letter, supporting an alternative rationale for the non-current classification of the liability component of a compound financial instrument. IAS 32 requires the equity and liability components of a compound financial instrument to be accounted for separately. Because IAS 1 addresses the presentation of liabilities (not equity), the comment letter suggested that the equity component should be ignored in determining whether the liability component should be presented as current or non-current in accordance with IAS 1.

The IFRIC decided that both rationales should be drawn to the attention of the Board with a request for clarification. The IFRIC decided not to take the issue onto its own agenda.