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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**ED Annual Improvements Process 2007 – Comment analysis**
Subject:	**IAS 1 Classification of the liability component of a convertible instrument (Question 5) (Agenda paper 11E)**

INTRODUCTION

1. The purpose of this agenda paper is to summarise the staff's analysis of the comments received on the proposed amendment in Question 5 of the annual improvements ED:

   Question 5 Do you agree with the proposal to clarify that the potential settlement of a liability by the issue of equity is not relevant to its classification as current? If not, why?

BACKGROUND

2. The Board considered the classification of the liability component of a convertible instrument as current or non-current. Paragraph 69(d) of IAS 1 states that when an entity does not have an unconditional right to defer settlement of a liability for at least twelve months after the reporting period, the liability should be classified as current. According to the *Framework*, conversion of a liability into equity is a form of settlement.

3. The application of these requirements means that if the conversion option can be exercised by the holder at any time, the liability component would be classified as current. This classification would be required even if the entity would not be required to settle unconverted instruments with cash or other assets for more than twelve months after the reporting period.

4. 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.

5. 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 it proposed to amend IAS 1 accordingly.

6. The Exposure Draft proposed amending IAS 1 paragraph 69 (d) by adding new text (underlined):

Current liabilities

69 An entity shall classify a liability as current when:

(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 period; or

(d) it does not have an unconditional right to defer settlement of the liability <u>by the transfer of cash or other assets</u> for at least twelve months after the reporting period (see paragraph 73).

An entity shall classify all other liabilities as non-current.

COMMENT ANALYSIS

7. Of the 75 comment letters received by the Board, 26 commented on this issue. A majority of respondents support the proposed changes.

   "The current standard is flawed by giving the term "settlement "too wide a meaning. The potential settlement of a liability by the issue of equity is not relevant to its classification because such a settlement is not an outflow of resources." (CL 58).

8. However, some of those who support the proposal recommend that the amendment address each of the five types of settlement mentioned in paragraph 62 of the *Framework*.

   "We agree that the Board's proposal will result in conversion of an obligation to equity not being relevant to the classification of a liability as current. However, paragraph 69(d) is difficult to read, as it contains 'double negatives', and only considers two of the five types of settlements that are mentioned in paragraph 62 of the *Framework*. For example, if a liability can be settled by the provision of services within the next12 months, revisions to paragraph 69(d) would effectively result in the liability being classified as non-current which we don't believe is the intention. We recommend that the amendment address each of the five types of settlements so that it is clear which types may be considered current and which may not."(CL 50)

9. Some respondents do not support the proposed amendment as they think that the proposal appears contrary to the *Framework.*

   "We do not agree with the proposed amendment. This proposal appears to be in conflict with the Framework. Paragraph 62(e) of the Framework states that settlement (which in context we understand to mean extinguishment) of a present obligation may occur through the conversion of the obligation to equity. We believe the principle in the Framework is correct and that any amendment of IAS 1.69(d) should reflect this principle." (CL 44)

Staff Analysis

10. Paragraph 62 of the *Framework* says:

"The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights."

11. The intention of the proposal in the ED was to clarify the classification of liability component of *a convertible instrument*. However, some respondents read the proposal as implying that *all* liabilities that will be settled other than by the transfer of cash or other assets are *always* classified as non-current liabilities. They read "For example, instruments that are settled through the provision of services or the replacement of an obligation with another obligation would always be classified as non-current liabilities under the amended IAS1. 60 (d)" (CL 75).

12. Therefore, these respondents think that the proposed amendment is linked to (a) and (b) in paragraph 10. They recommend that the amendment address the other types of settlement identified in (c) – (e) so that it is clear which types may be considered current and which may not.

13. In particular, as to (e), they request that Board clarify the classification of a liability that requires delivery of a variable number of shares in accordance with paragraph 21 of IAS 32. “AC agrees that in general the potential settlement of a liability by the issue of equity should not affect its classification as current or non-current where the holders’ conversion option is for a fixed number of equity shares. However, in the special case of a liability that is settled by the issue of a variable number of shares (as described in paragraph 21 of IAS 32), AC considers that the classification as current or non-current should depend on the due date for settlement and if the holder had an option to require conversion at any time then this should be disclosed as current” (CL 54)

Staff recommendation – approach

14. Potential options for this amendment include the following:

(a) Approve the currently proposed amendment without change;

(b) Revise the amendment and re-expose for comment as a separate exposure draft or as part of the next round of Annual Improvements; or

(c) Reject the currently proposed amendment and drop from Annual Improvements. Instead incorporate this question in the Financial Statement Presentation project to deal with classification of all liabilities comprehensively.

15. The staff does not support option (a) as the respondents are concerned about the currently proposed amendment. The staff does not support option (c) as it does not resolve the originally proposed question on a timely basis. The staff agrees with respondents who believe that the proposed amendment will apply to all liabilities not just those that are components of convertible instruments. Consequently, the amendment as drafted has much broader consequences than the question originally posed. In addition, the staff agrees with respondents who assert that, although the settlement of an obligation to provide services may not

consume cash or other assets directly, it will necessarily consume entity resources. Non-current classification should not therefore always be assumed.

16. The staff recommends option (b) as it can timely resolve the originally proposed question and also resolve the respondents' concern about the currently proposed amendment. In this approach, the staff recommends that the Board focus on the originally proposed question and directly answer it, rather than trying to comprehensively modify the wording to address all the ways liabilities can be settled as noted in the *Framework*.

Question for the Board

17. **Does the Board agree with the staff's recommendation in paragraph 16? If not, what does the Board recommend and why.**

Staff recommendation – the revised wording

18. If the Board would like to proceed with this issue following option (b), the staff recommends revised wording that would answer the original question. The staff has developed two possible versions of the amendment and asks the Board which it prefers.

19. Option 1 (repeating a part of the beginning of sub-paragraph d)

Current liabilities

69 An entity shall classify a liability as current when:

(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 period; or

(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). <u>The potential settlement of a liability by the issue of equity instruments is not relevant to the determination of whether it has an unconditional right to defer settlement.</u>

20. Option 2 (using the words from the question in the Exposure Draft)

Current liabilities

69 An entity shall classify a liability as current when:

(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 period; or

(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). <u>The potential settlement of a liability by the issue of equity instruments is not relevant to its classification as current.</u>

Question for the Board

21. **Which option does the Board prefer?**