IFRS

Agenda Paper 12B

STAFF PAPER

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Project	**IAS 1 *Presentation of Financial Statements* Current/non-current classification of liabilities**
Paper topic	Conditions that are tested after the end of the reporting period

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Purpose

1. In the Exposure Draft, *Classification of Liabilities* ('the ED'), the International Accounting Standards Board® ('the Board') proposed clarifications to the requirements of IAS 1 *Presentation of Financial Statements* relating to the classification of liabilities as either current or non-current. In these proposals:

   (a) Classification would be based on rights that were in existence at the end of the reporting period. A liability is classified as current unless the entity has a right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

   (b) In situations where the right to defer settlement for a period greater than twelve months 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 classification.

2. Several respondents to the Board's public consultation on these proposals asked how an entity would assess compliance with a condition, within the agreement with the lender, when that condition is not subject to testing, or is not capable of being tested, until after the reporting period.

3. In this paper, the staff discuss the circumstances relating to the assessment of compliance with a condition after the reporting period through the use of

examples. The staff do not recommend revising the Board's proposals, but asks the Board whether wording from the Basis of Conclusions should be included in the Standard to make the Board's intentions clearer.

4. The staff intend presenting papers at a future meeting of the Board that examine the proposed requirements with respect to the transfer of equity as a means of settlement and that confirm the Board's proposals by reference to some specific types of transactions raised in the comment letters.

Structure of this paper

5. This topic is organised as follows:
   (a) effect of events after the reporting period on a right to defer settlement;
   (b) conditions that are tested after the reporting period;
   (c) annual review carried out after the reporting period; and
   (d) staff summary and recommendation.

Effect of events after the reporting period on a right to defer settlement

6. There were three inputs to the Board's proposal that classification of liabilities as current or non-current should be based on rights at the end of the reporting period and on compliance with those rights as at the end of the reporting period. These inputs were:
   (a) the original guidance in the Standard before the Board's proposed amendments;
   (b) guidance contained in IAS 10 *Events after the Reporting Period*; and
   (c) examples discussed by the Board in developing its proposals.

Original guidance in the Standard

7. The Standard before the Board's proposed amendments contained requirements with respect to the effect of events after the reporting period on the classification of liabilities as either current or non-current. These requirements, summarised below, analyse those circumstances that create a right to defer settlement and

thereby determine classification as at the end of the reporting period and those that do not.

Does not create a right to defer settlement in accordance with 69(d); classify the liability as current	***Creates a right to defer settlement in accordance with 69(d); classify the liability as non-current***
A right is not created as at the end of the reporting period by agreements entered into after the reporting period. Circumstances include:	**A right is created as at the end of the reporting period by agreements entered into before the end of the reporting period. Circumstances include:**
an agreement to refinance or reschedule repayments is completed after the reporting period (paragraph 72); refinancing on a long-term basis is agreed after the reporting period; (paragraph 76) a breach is rectified after the reporting period (paragraph 76); the lender agrees after the reporting period not to demand payment (paragraph 74); or a period of grace is granted after the reporting period (paragraph 76).	an agreement to roll over a liability is in place at the end of the reporting period (paragraph 73). the borrower is in breach, but the lender agrees by the end of the reporting period to provide a period of grace (paragraph 75).

8. The Board thought that it was clear from the guidance (above) that:

   (a) classification is based on the rights that exist at the end of the reporting period;

   (b) agreements reached after the reporting period will not create a right at the end of the reporting period;

   (c) changes made to a right to defer settlement that are made after the end of the reporting period do not affect the classification of liabilities at the end of the reporting period; and

   (d) rectifying a breach after the reporting period does not affect a right to defer settlement and consequently does not affect classification as at the end of the reporting period.

Requirements contained in IAS 10

9. The objective of IAS 10 is to prescribe when an entity should adjust its financial statements for events after the reporting period. This Standard distinguishes between an adjusting event and a non-adjusting event.

> 3 … Two types of events can be identified:
>
> (a) those that provide evidence of conditions that existed at the end of the reporting period (*adjusting events after the reporting period*); and
>
> (b) those events that are indicative of conditions that arose after the reporting period (*non-adjusting events after the reporting period)*.

10. The Board considered the effect of that distinction during its discussion about the impact of events after the reporting period on the classification of liabilities. It concluded that classification is based on conditions as at the reporting date and consequently only adjusting events, ie those that provide evidence of conditions that existed at the end of the reporting period, should affect the classification of liabilities as at the reporting date. Changes to a right to defer settlement that are indicative of conditions that arise after the reporting date would be non-adjusting events and would not affect the classification of liabilities.

Examples discussed by the Board in developing its proposals

11. The Board received evidence that there was diversity in practice with respect to the effect that events after the reporting period had on the classification of liabilities. In particular, an assessment of the effect of events after the reporting period on the classification of liabilities that were subject to a condition did not always result in a consistent classification decision.

12. In order to assess whether the Board's proposed requirements for the classification of a liability were clear, capable of being consistently applied and complete, the Board applied its proposed requirements to a number of examples discussed at its October 2013 and March 2014 meetings. Its findings and conclusions are summarised in the table below.

An entity is due to settle a liability previously classified as non-current, six months after the year end.	***Classification and basis of classification***
No arrangement to extend the existing loan has been agreed at the end of the reporting period.	Current Paragraph 69(d): the entity does not have a right at the end of the reporting period to defer settlement.
After the end of the reporting period, the entity makes an agreement with the lender to extend the existing liability for more than 12 months from the end of the reporting period.	Current. Example already covered. Explicit in paragraph 73R(b) (formerly paragraph 72). Disclose waiver in accordance with IAS 10
The liability will be refinanced using the proceeds of a new loan that is agreed with a new lender at the end of the reporting period.	Current Explicit in paragraph 72R (formerly paragraph 73) that the entity does not have a right to defer settlement of the existing loan facility.
The Board concluded that only rights to defer settlement that are in existence at the end of the reporting period can affect the classification of a liability.	
The entity has an arrangement at the end of the reporting period to extend the loan, but is in breach of the conditions of the loan arrangement as at the end of the reporting period.	Current Paragraph 69(d) The entity does not have a right at the end of the reporting period to defer settlement because the entity is in breach as at the reporting date.
The entity has an arrangement at the end of the reporting period to extend the existing loan but is in breach of the conditions of the loan arrangement at that date. The breach is remedied after the reporting period.	Current Example already covered. Explicit in paragraph 73R(c) (formerly paragraph 76). Disclose subsequent remedy in accordance with IAS 10.
The entity has an arrangement at the end of the reporting period to extend the existing loan but at that date is in breach of the conditions of the loan arrangement. A waiver of the breach of conditions is obtained after the reporting period.	Current. Example already covered: explicit in paragraph 73R(a) (formerly paragraph 74.) Disclose waiver in accordance with IAS 10.
The entity has an arrangement at the end of the reporting period to extend the existing loan but at that date is in breach of the conditions of the loan arrangement. A 12 month waiver of the breach of conditions is obtained before the end of the	Non-current Example already covered. Explicit in paragraph 72R(b) (formerly paragraph 75).

reporting period to extend the existing loan arrangement.	
The Board concluded that when a right to defer settlement 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 classification at the end of the reporting period.	

Conditions that are tested after the end of the reporting period

13. In the comment letters received in response to the ED, some respondents asked about circumstances in which they thought it was difficult to assess whether the entity was in compliance with any conditions at the reporting date and whether, in accordance with the Board's proposals, the entity had a right to defer settlement as at the reporting date.

14. Several of these respondents asked about rights that are subject to a condition that will be tested only after the end of the reporting period. Two examples were cited:

    (a) Compliance with the condition is tested at a specified date after the reporting period, typically the anniversary of granting the loan.

    (b) Compliance with the condition is based on a calculation with reference to the financial position as stated in the audited financial statements, and those audited financial statements are not available until after the end of the reporting period.

15. These examples are discussed below.

Example (a): testing conditions at a specified date

16. Some comment letter respondents asked whether a right to defer settlement should affect an assessment of classification as at the end of the reporting period if a condition of that right was not due to be assessed until after the reporting period. They considered two aspects of such a right to defer settlement:

    (a) Did the right exist as at the end of the reporting period if a condition of the right is subject to testing after the reporting period? and

(b) How should compliance with the condition that is to be tested after the reporting period be assessed as at the end of the reporting period?

The right at the end of the reporting period

17. Respondents questioned the existence and nature of such a right as at the end of the reporting period. Respondents expressed two views:

(a) Some thought that the entity did not have a right to defer settlement as at the reporting date. They took the view that the right is not in place at the end of the reporting period because the condition is not tested, or satisfied, until a future date. In accordance with that view, because the condition cannot be satisfied at the end of the reporting period, the right itself cannot exist. The condition can only be applied at the date stated in the agreement and the right can only 'vest', therefore, at that future date. At the end of the reporting period no right to defer settlement is in place and, consequently, a right that is conditional on a future test cannot affect classification.

(b) Others thought that the right to defer settlement is not subject to a condition as at the reporting date because the condition is not due to be tested at the end of the reporting period. In accordance with this view, the right to defer settlement could never be breached as at the end of the reporting period–it could only be breached at a future date because the condition only applies at a future date. In accordance with this view, the right will affect classification as at the end of the reporting period because it is not, at that time, subject to any condition.

Staff analysis

18. In the staff analysis:

(a) there is a right to defer settlement at the end of the reporting period because the agreement has been entered into before the end of the reporting period; and

(b) conditions are attached to that right.

19. The staff considered the effect on classification of compliance with conditions tested after the reporting period in terms of the objective of the condition set by

the lender. In the staff's view, the objective of these types of conditions is to protect the lender's interests.

20. This protection can be achieved in different ways. For example, some arrangements may focus on preventing the entity from exceeding certain borrowing limits. That 'safe' borrowing limit may be expressed in absolute monetary value or in terms of a gearing ratio. Alternatively, the condition may be one that has as its objective the protection of future cash inflows to ensure the loan can be repaid. Such a condition might be expressed, for example, as a covenant not to exceed certain expenditure limits for individual types of transactions.

21. Whatever the form of the condition contained in the agreement, the staff think that this type of condition is included in the loan agreement to protect the lender's loan and to ensure, as far as possible, that the entity will be able to repay the loan and any interest due.

22. In order for the condition to be effective in protecting the lender's interest, therefore, the staff think that protection must be in place continuously. The lender's interest is not protected if gearing is less than the stated amount on one day specified in the arrangement, but is breached on every other day. Consequently, the staff think that the lender's objective in making such a condition is that the entity *complies* with the condition continuously throughout the period of the loan, even though the lender only intends to *test* that compliance on a stated date. The staff think that the right to defer settlement is implicitly conditional on complying with the conditions specified by the lender, even if that condition is tested only on a specified date or dates.

23. The staff think the lender's objective in including the condition in the loan agreement differs from any consideration of the lender's intent or expectations about events after the reporting period. When the Board discussed the effect of management intent or expectations about events after the reporting period, they concluded that these expectations should not affect classification. They were concerned that it would place too much emphasis on management intent and that it would be an exception to IAS 10. The staff think that considering the objective of the condition is a different consideration from a lender's expectation or intent about events after the reporting period. Including that consideration of objective provides more information about the nature of the right itself.

24. Accordingly, the staff think that whether or not the entity complies with the condition, as at the reporting date, *is* relevant to the classification of the loan. The lender is relying effectively on continual compliance with the condition to protect its interest.

25. In the staff's view, the classification assessment, in the example of a right subject to a condition that is tested after the end of the reporting period, is made in the same way as any other assessment of a right to defer settlement, ie in accordance with compliance with the condition as at the end of the reporting period.

Example (b): reliance on audited financial statements

26. In some loan arrangements, the conditions required by the lender are explicitly required to be verified by reference to the audited financial statements. The staff think that it is clear that if compliance is based on a calculation made with reference to the financial position as stated in the audited financial statements, compliance with that condition is being assessed as at the end of the reporting period.

27. In accordance with IAS 10, this verification process would qualify as an adjusting event because the verification process provides evidence of conditions that existed at the end of the reporting period. Classification would be based on the financial position of the entity as at the end of the reporting period, and compliance with any conditions would be assessed using evidence of those conditions from the audited financial statements, obtained after the reporting period.

Annual review clause carried out after the reporting period

28. Several respondents raised the circumstances of an annual clause as an example of a right to defer settlement that is affected by events after the reporting period. In this situation, the right to defer settlement is subject to a review by the lender after the reporting period. At the time of that review, the lender has the right to request early repayment, subject only to a short notice period. The lender's decision to request early repayment is not dependent on compliance with any specified conditions.

29. We think that an annual review clause contrasts the two earlier examples that tested compliance with a condition at a date after the end of the reporting period.

30. In the annual review example, we think that as at the end of the reporting period the entity does not have a right to defer settlement for more than twelve months. The entity only has a right to defer settlement to the date of the annual review. At that date, the lender has a right to require repayment of the loan irrespective of whether the entity has complied with any conditions as at the end of the reporting period or to date.

31. The entity may expect to continue with the loan facility but it only has a *right* to defer settlement of the loan up to the date of the annual review. If the annual review date is less than twelve months from the end of the reporting period, we think that such a loan would be classified as current, whether or not the entity expects the lender to recall the loan and whether or not the entity complies with any other conditions that otherwise apply.

Staff summary and recommendation

Example (a): testing conditions at a specified date

32. The staff think that in the case where a condition is tested after the end of the reporting period, the right exists at the end of the reporting period but it is subject to a condition. An assessment about whether the entity complies with the condition would be made in the same way as any other right to defer settlement would be assessed, ie by compliance as at the reporting date.

33. Whether or not, as at the end of the reporting period, the entity satisfies the test that forms the basis of the condition determines whether the right should affect classification as at the end of the reporting period, notwithstanding the fact that the test is defined as at another date.

Example (b): reliance on audited financial statements

34. The staff think that a condition that relies on information in the audited financial statements is a condition that is being assessed as at the end of the reporting period. Consequently, compliance with the condition at that date is an adjusting event and the liability will be classified at the reporting date in accordance with

that assessment of compliance, for which the audited financial statements provide evidence.

Question 1
Do you agree with the staff's analysis and with the staff's assessment that a right that is tested after the end of the reporting period is a right as at the end of the reporting period and compliance with any conditions is assessed as at the reporting date?

35. This conclusion is consistent with the Board's proposals:

> BC4 The Board considered a number of examples of conditions that could be placed on exercising a right. The Board concluded 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 classification.

36. The staff agree with the suggestion made by a number of respondents that this conclusion is significant in making an assessment of the classification of liabilities and that this requirement should be included in the Standard itself rather than in the Basis for Conclusions.

Question 2
Do you agree that the conclusion in BC4–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 classification–should be added to the requirements of the Standard?

Annual review carried out after the reporting period

37. The staff think that in the case of a loan that is subject to an annual review at which the lender can request early repayment, the entity has a right to defer settlement of the loan only to the date of the annual review. If that date is less than twelve months from the end of the reporting period, the liability is classified as current.

Question 3

Do you agree that the staff's conclusion that in an agreement that includes an annual review clause as described in this paper, the entity only has a right to defer settlement up to the date of the annual review?

38. If the Board agrees with the staff's conclusion that the entity only has a right to defer settlement up to the date of the annual review, at the end of the reporting period the entity will have a right to defer settlement to the annual review date specified in the agreement. If that date is less than twelve months from the end of the reporting period the loan will be classified as current; if it is greater than twelve months it will be classified as non-current in accordance with paragraph 69(d) of the Standard. Accordingly, the staff does not think that the Board's proposals need to be amended for the circumstances when a loan is subject to an annual review clause.

Question 4

Do you agree that the staff's recommendation that the Board's proposals are not amended with respect to an annual review clause?