STAFF PAPER

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March IASB Meeting

Project	**Annual Improvements to IFRSs 2010-2012 cycle—Comment letter analysis**
Paper topic	IAS 1 *Presentation of Financial Statements*—Current/non-current classification of liabilities

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Introduction

1. The Exposure Draft *Annual Improvements to IFRSs 2010-2012 cycle* published in May 2012 (hereafter, the ED) proposed to amend IAS 1 *Presentation of Financial Statements* to clarify that a liability is classified as non-current if an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility **with the same lender, on the same or similar terms**.
2. After considering the comments received from the respondents, the IFRS Interpretations Committee (the Interpretations Committee) decided to recommend to the IASB that it should **not** confirm the proposed amendment to IAS 1 in its current form.
3. The Interpretations Committee noted that the proposed amendment proposes to tie the classification requirements of financial liabilities in IAS 1 to the derecognition requirements of financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*. The Interpretations Committee noted that, in that case, the assessment of whether the terms are the same or similar would include a quantitative analysis based on the so-called '10 per cent test'. The Interpretations Committee thinks that this test is not appropriate for classification purposes and would raise practical issues.
4. The Interpretations Committee decided to recommend to the IASB that:

(a) it should **not confirm** the proposed amendment to IAS 1 in its current form; and

(b) this issue should rather be addressed through a narrow-scope project to amend IAS 1.

Objective of this paper

5. The objective of this paper is:

(a) to provide background information on the issue;

(b) to summarise the Interpretations Committee's discussions and recommendations on this issue;

(c) to obtain a decision from the IASB on whether it agrees not to finalise this annual improvement;

(d) to ask the IASB whether it agrees to address issues relating to the classification of financial liabilities as current or non-current as part of a narrow-scope project to amend IAS 1; and

(e) if so, to ask the IASB its views on what the scope of this project should be.

Structure of this paper

6. The structure of the paper is the following:

(a) Background;

(b) Interpretations Committee's discussions and recommendations;

(c) Proposed scope of the project to amend IAS 1; and

(d) Appendix A: fact patterns illustrating the issue.

Background

Current guidance in IAS 1 regarding current/non-current classification of liabilities

7. IAS 1 provides the following guidance regarding the classification of liabilities as current or non-current:

> 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)**. 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.
>
> An entity shall classify all other liabilities as non-current.
>
> 72 An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:
>
> (a) the original term was for a period longer than twelve months, and
>
> (b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.
>
> 73 **If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period**. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

Issue that led to the proposed amendment

8. The Interpretations Committee was asked to clarify the criteria for classification of liabilities as current or non-current in paragraph 69(d), when read with

paragraph 73. The issue is whether a liability should be classified as non-current in the following situations:

(a) The entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility **with a new lender (regardless of the terms)**.

(b) The entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility **with the same lender, on the same or similar terms**.

(c) The entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility **with the same lender at different terms**.

The IASB's proposal to address the issues raised

9. The IASB and the Interpretations Committee both agreed to propose to link the classification requirements of financial liabilities in IAS 1 with the derecognition requirements of financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments*. According to paragraphs 40 of IAS 39 and 3.2.2 of IFRS 9, an exchange between an existing borrower and lender of debt instruments with **substantially different terms, or a substantial modification of the terms of an existing liability,** shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. According to the Basis for Conclusions of the proposed amendment to IAS 1:

> BC1 …
>
> The Board observed that there is currently diversity in practice on the classification of liabilities when different loan terms apply. According to paragraph 3.2.2 of IFRS 9 and paragraph 40 of IAS 39, a substantial modification of the terms of an existing liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
>
> BC2 As a result, the Board thinks that if an entity expects, and has the discretion to refinance, an existing loan on substantially different terms, then classification of the loan as non-current at the reporting date

> would not be consistent with the derecognition guidance for financial liabilities if this existing loan would be derecognised less than twelve months after the reporting date, and replaced by the new refinanced loan facility at that time. Consequently, the Board proposes to amend the wording of paragraph 73 to clarify that, for the paragraph to apply, and for an existing loan that is due within twelve months of the reporting date to be classified as non-current, an entity must expect, and have the discretion to refinance, the loan for at least twelve months after the reporting period with the same lender, on the same or similar terms. In the Board's view, terms are similar if the amendment of the terms would be expected to result in no substantial change to the rights and obligations of the parties to the loan facility.

10. The proposed amendment to IAS 1 is shown below (new text is underlined):

> 73 If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility <u>with the same lender, on the same or similar terms</u>, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period...

Interpretations Committee's discussions and recommendations

11. After considering the comments received from respondents, the Interpretations Committee decided to recommend to the IASB that it should **not confirm** the proposed amendment to IAS 1 in its current form, for the following reasons:

    (a) the amendment to IAS 1 is not clear in its current form. The Basis for Conclusions of the proposed amendment seems to indicate that the classification of a financial liability should depend on whether the financial liability will be derecognised less than 12 months after the reporting date. The Interpretations Committee does not think that all liabilities that are derecognised less than 12 months after the reporting period should be classified as current. They note that this would significantly change the current practice. See detailed analysis below.

    (b) the classification requirements for financial liabilities in IAS 1 should **not be tied** to the derecognition requirements for financial liabilities in IAS 39/IFRS 9. Indeed, in that case, the assessment of whether the terms are the same or similar will include a quantitative analysis based on the so-called '10 per cent test'. The Interpretations Committee thinks that this test is not appropriate for classification purposes and would raise practical issues. See detailed analysis below.

(c) there are a number of issues associated with the classification of financial liabilities that were not dealt with in the proposed amendment to IAS 1. The Interpretations Committee think that the classification of financial liabilities as current or non-current is essential information for users of the financial statements. The Interpretations Committee think that it should deal with this issue as part of a narrow-scope project to amend IAS 1 (and not through an annual improvement). See section below regarding the scope of the project to amend IAS 1.

The proposed amendment to IAS 1 is not clear in its current form

12. In many cases, the terms of the original loan do not give the borrower the right to roll over the loan. Instead, the borrower and the original lender agree a new loan facility (which is different from the original loan facility) that gives the borrower the right to roll over the original loan into the new loan facility when the original loan matures (see for example Fact pattern 2 in Appendix A).

13. In that case, the current practice is to classify the original loan as non-current if the borrower expects, and has the discretion, to roll over the original loan into the new loan facility for at least twelve months after the reporting period, provided that the terms of the original loan and new loan are the same or similar. In other words, the ‘existing loan facility’ at the end of the reporting period as mentioned in paragraph 73 of IAS 1 (which gives the borrower the right to roll over the loan) is the new loan facility (and not the original loan facility).

14. However, if the IASB were to base the classification of a liability on whether it will be derecognised less than 12 months after the reporting date, the liability to repay the original loan would be classified as current in the situations described above, even if the original loan is refinanced or rolled over (for at least 12 months after the reporting period) on the same or similar terms. Indeed, the liability to repay the original loan is derecognised in accordance with the requirements in IAS 39/IFRS 9 at the date of rollover or refinancing, because it is extinguished when the original loan matures.

15. For example, in Fact patterns 2 to 5 described in Appendix A of this paper, the liabilities would all be classified as current because the original liability is extinguished at the date the original loan matures and is therefore derecognised at this date. The Interpretations Committee does not think that all liabilities that are derecognised less than 12 months after the reporting period should be classified as current.

The classification requirements for financial liabilities in IAS 1 should not be tied to the derecognition requirements for financial liabilities in IAS 39/IFRS 9.

16. If the classification requirements for financial liabilities in IAS 1 are tied to the derecognition requirements for financial liabilities in IAS 39/IFRS 9 (respectively paragraphs 40 and 3.3.2), the assessment of whether the terms are the same or similar will be based on both a qualitative analysis and a quantitative analysis (ie the so-called '10 per cent test'). The Interpretations Committee thinks that the '10 per cent test' is not appropriate for classification purposes and would raise practical issues. Indeed, according to IAS 39/IFRS 9 (paragraphs AG32 of IAS 39 and B.3.3.6 of IFRS 9), the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least **10 per cent different** from the discounted present value of the remaining cash flows of the original financial liability.

17. The Interpretations Committee noted that this test was initially developed for derecognition purposes (and not for classification purposes). It also noted that if the IASB decides to use the derecognition requirements in IAS 39 to assess whether the terms are the same or similar, entities would have to apply the '10 per cent test' for classification purposes, despite the fact that it is not needed for derecognition purposes. Indeed, as mentioned above, in many cases, the original loan that is rolled over or refinanced is extinguished when it matures, and the corresponding liability is therefore derecognised. In those cases, entities do not need to assess whether the loan is refinanced or rolled over on the same or similar terms within the context of the derecognition requirements (and therefore do not need to apply the '10 per cent test'). Entities only need to apply the '10 per cent test' within the context of the derecognition requirements when the original loan

is replaced before it matures, or when the terms of the original loan are modified before it matures (such as in Fact pattern 6 described in Appendix A).

18. The Interpretations Committee also noted that the application of the '10 per cent test' would raise practical issues, as mentioned by some of the respondents. For most rollover or refinancing agreements, the interest rate of the new loan is reset at the date of rollover or refinancing, ie after the reporting date. However, the '10 per cent test' would have to be performed at the reporting date for classification purposes. This raises the question of how the cash flows of the rolled-over loan would be decided. One solution would be to use forward rates, but this would add additional complexity for many entities.

19. Lastly, as noted by some respondents, the outcome of the '10 per cent test' does not seem to conform to the principles in IAS 1. Indeed, the '10 per cent test' is mainly based on the difference between the new interest rate and the original interest rate. This means that the likelihood of classification of a liability as current would increase if the loan is rolled over or refinanced for a longer period (eg for 10 years instead of for 1 year), because the interest rate generally rises as maturity lengthens. This does not seem an appropriate outcome. As a result, for all the reasons mentioned above, the Interpretations Committee does not think that the '10 per cent test' is appropriate for classification purposes.

Questions to the IASB
1. Does the IASB agree not to confirm the proposed amendment to IAS 1 in its current form? 2. Does the IASB agree to address issues regarding the classification of liabilities as current or non-current as part of a narrow-scope project?

Proposed scope of the project to amend IAS 1

20. Assuming that the IASB agrees to address issues regarding classification of liabilities as current or non-current as part of a narrow-scope project, we think that the scope of the project should address the issues that are linked to paragraphs 69 (d) and 73 of IAS 1. The project would therefore address the following questions:

(a) What is the meaning of the words ‘unconditional right’ in paragraph 69 (d) and ‘discretion’ in paragraph 73?

(b) What is the meaning of the words ‘settlement of the liability’ in paragraph 69 (d) and ‘refinance or roll over an obligation’ in paragraph 73?

Questions to the IASB
3. Does the IASB agree with the staff’s proposals to address issues that are linked to paragraphs 69 (d) and 73 of IAS 1 as part of a narrow-scope project on the classification of liabilities?

Appendix A: Fact patterns illustrating the issue

A1. We provide below several fact patterns that illustrate the issue.

Fact pattern 1

> Fact pattern 1: Entity A has an outstanding floating interest rate loan under a loan facility with Bank B that is due to be repaid 6 months after the end of the reporting period. Under the terms of the loan facility:
>
> - Entity A has the discretion to roll over the loan for another 12 months when the loan matures;
>
> - if Entity A decides to roll over the loan when it matures, the floating interest rate of the loan is reset to the floating market rate at the date of rollover.

A2. In Fact pattern 1, it should be noted that:

(a) the terms of the original loan facility give Entity A the right to roll over the loan when it matures. In other words, the 'existing loan facility' as mentioned in paragraph 73 of IAS 1 (which gives Entity A the right to roll over the loan) is the **original** loan facility;

(b) the interest rate reference of the loan is not changed (ie it remains the same floating rate reference). However, the interest rate is reset to market rates, ie the floating interest rate is adjusted to reflect the risk-free rate and the spread at the date of reset (including the debtor's credit risk, other risk components at the date of reset and margin elements).

Fact pattern 2

> Fact pattern 2: Entity A has an outstanding floating interest rate loan under a loan facility with Bank B that is due to be repaid 6 months after the end of the reporting period. Under the terms of this loan facility (referred to as the original loan facility), Entity A does **not** have the discretion to roll over the loan when the loan matures. Before the end of the reporting period, Entity A and Bank B agree a new loan facility that expires in 3 years. Under the terms of the new loan facility:
>
> - Entity A has the discretion to roll over the original loan into the new loan facility when the original loan matures (and to maintain the outstanding balance of the original loan for the term of the new loan facility, ie 3 years);
>
> - if Entity A decides to roll over the original loan into the new loan facility when the original loan matures, the floating interest rate of the loan is reset to the floating market interest rate at the date of roll over into the new loan facility; and
>
> - the other terms of the original loan are not modified.

A3. In Fact pattern 2, it should be noted that:

(a) the terms of the original loan facility do not give Entity A the right to roll over the loan when it matures. Instead, it is the terms of the new loan facility (agreed by Entity A and Bank B before the end of the reporting period) that give Entity A the right to roll over the original loan (into the new loan facility). In other words, the 'existing loan facility' as mentioned in paragraph 73 of IAS 1 (which gives Entity A the right to roll over the loan) is the **new** loan facility.

(b) The interest rate reference of the loan is not changed (ie it remains a floating rate reference). However, the interest rate is reset to market rates, ie the floating interest rate is adjusted to reflect the risk-free rate and the spread at the date of reset (including the debtor's credit risk, other risk components at the date of reset and margin elements).

Fact pattern 3

Fact pattern 3: same fact pattern as Fact pattern 2, except that under the terms of the new loan facility: - if Entity A decides to roll over the original loan into the new loan facility when the original loan matures, the floating interest rate of the loan is reset to a fixed market interest rate at the date of rollover into the new loan facility. - there is a substantial change in covenants.

A4. In Fact pattern 3, it should be noted that the interest rate reference of the new loan facility is modified (from a floating interest rate to a fixed interest rate) and there is a substantial change in covenants.

Fact pattern 4

Fact pattern 4: same fact pattern as Fact pattern 2, except that under the terms of the new loan facility, if Entity A decides to roll over the original loan into the new loan facility when the original loan matures, Entity A has the choice of resetting the interest rate of the loan rolled over into the new loan facility at a fixed market interest rate, or at a floating market interest rate, at the date of rollover into the new loan facility.

A5. In Fact pattern 4, it should be noted that the interest rate of the loan that is rolled over into the new loan facility is not yet decided at the end of the reporting period (although there is an existing loan facility at the end of the reporting period that gives Entity A the right to roll over the loan when it matures).

Fact pattern 5

Fact pattern 5: same fact pattern as Fact pattern 2, except that the new loan facility is agreed with Bank C (and not with Bank B).

A6. In Fact pattern 5, it should be noted that the lenders are different, ie the existing loan and the new loan facility are with different banks.

Fact pattern 6

Fact pattern 6: Entity A has an outstanding fixed-interest-rate loan under a loan facility with Bank B that is due to be repaid 6 months after the end of the reporting period. Under the terms of this loan facility (referred to as the original loan facility), Entity A does **not** have the discretion to roll over the loan when the loan matures. Before the end of the reporting period, Entity A and Bank B agree to exchange the original loan (before it matures) for a new loan that expires in 3 years. Under the terms of the new loan facility: - Entity A and Bank B agree that there is no transfer of cash at the date of exchange of the loans; - the interest rate of the new loan is set to a market floating interest rate at the date of exchange; and - Entity A agrees to pay a fee to Bank B at the date of exchange.

A7. In Fact pattern 6, it should be noted that the original loan is replaced by a new loan before the original loan matures. Another, similar, fact pattern would be a modification of the terms of the original loan (before the original loan matures).