

Mr Michael Stewart
Director of Implementation Activities
IFRS Foundation
30 Cannon Street
London
EC4M 6XH

19 May 2015

Dear Michael,

This letter sets out the comments of the UK Financial Reporting Council (FRC) on the Exposure Draft (ED) '*Classification of Liabilities (Proposed amendments to IAS 1)*'.

Diversity in application of paragraphs 69 to 76 of IAS 1 *Presentation of Financial Statements*, which outline the requirements for the classification of liabilities, suggests that there is a need for clarification of the requirements. We believe that the amendments proposed in the ED will remove inconsistencies in terminology and make the existing requirements clearer, resulting in more consistent application in the short-term.

However, we believe that the IASB should review the underlying principles for classification. Using formal rights as the basis for classification may not always provide the most relevant information and we encourage the IASB to carry out research with investors to understand better their information needs in this area.

Our main comments on the ED are summarised below with our detailed responses to the consultation questions included in the appendix to this letter.

a) *Formal rights as the basis for classification*

The basis for conclusions of both the existing standard and the ED make it clear that the IASB intends the classification of liabilities to be based on formal rights in existence at the reporting date. In some cases this may result in counter-intuitive classification of a liability that may be inconsistent with other publicly available information. We believe that the IASB should perform further research to determine whether classifying liabilities based on substantive rights would provide more useful information and better reflect economic reality. The interaction of any proposed change to the basis for classification with the requirements of IAS 10 *Events after the Reporting Period* would also need to be considered carefully.

b) Linking settlement with the outflow of resources

The new sentence inserted at the end of paragraph 69, which links settlement of a liability with the outflow of resources (including the transfer of equity instruments), in some cases is inconsistent with the existing requirement in paragraph 69(d) which 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.' We request that the IASB clarifies the interaction between these requirements.

c) Further clarification on the application of the existing requirements

In most cases, we believe that the existing requirements for the classification of liabilities according to formal rights are clear. However, we have identified two additional situations where the requirements remain unclear, despite the proposed amendments. Different interpretations of what is meant by 'conditions in existence at the reporting date' may lead to diversity in application when:

- i. the terms of a contract do not require the entity to test for compliance with a covenant at the reporting date, but the covenant would have been breached *if* the entity was required to test it at that date; or
- ii. the terms of a contract require that the test of compliance with a covenant at the reporting date is based on information that is not available at the reporting date, such as the annual audited financial statements, and a breach at the reporting date is therefore confirmed at a later date.

It would be helpful for IAS 1 to include additional examples to clarify how liabilities should be classified on the formal rights basis in each of these situations.

If you would like to discuss these comments, please contact me or Rosalind Szentpéteri on 020 7492 2474.

Yours sincerely

A handwritten signature in blue ink that reads "M McLaren". The signature is written in a cursive style and is underlined with a single horizontal line.

Melanie McLaren
Executive Director
Codes and Standards Division
DDI: 020 7492 2406
Email: m.mclaren@frc.org.uk

Appendix: responses to consultation questions

Question 1 – Classification based on the entity’s rights at the end of the reporting period

The IASB proposes clarifying that the classification of liabilities as either current or non-current should be based on the entity’s rights at the end of the reporting period. To make that clear, the IASB proposes:

- (a) Replacing ‘discretion’ in paragraph 73 of the Standard with ‘right’ to align it with the requirements of paragraph 69(d) of the Standard;
- (b) Making it explicit in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and
- (c) Deleting ‘unconditional’ from paragraph 69(d) of the Standard so that ‘an unconditional right’ is replaced by ‘a right’.

Do you agree with the proposed amendments? Why or why not?

Yes, we broadly agree that the proposed amendments will result in more consistent application of the requirements. However, we believe that the IASB should research whether classification of liabilities based on substantive rights would provide more useful information for investors.

Formal rights as the basis for classification

The standard requires that the classification of liabilities is based on the formal rights in existence at the reporting date. Paragraph BC16 states that the IASB believes that management’s intentions or expectations are not an appropriate basis for determining the classification of a liability. However, the requirement in paragraph 69(a) is not consistent with this; it states that a liability shall be classified as current when the entity ‘expects to settle the liability in its normal operating cycle’.

In our view, there are certain situations where classification of liabilities based on substantive rights would provide information that better reflects economic reality. For example, if compliance with a covenant is not required to be tested at the reporting date however it is clear that the covenant will be breached imminently after the reporting date, and the entity has no realistic course of action open to it to avoid the breach, it seems illogical for the liability to be classified as non-current because this does not reflect the substance of the conditions in existence at the reporting date.

As another example, when a covenant was breached during the reporting period and a waiver for at least twelve months received after the reporting period but before the financial statements are issued, a company would usually inform investors of the waiver yet is still required to classify the liability as current in its financial statements. It could be argued that this reduces the relevance of the information in the financial statements because the most

recent and relevant information is not reflected in the classification. On a substantive rights basis, a liability would be classified as non-current in these circumstances.

This issue is complex and we believe that further research is needed to establish how the classification of liabilities could provide clearer information for investors. We also recognise that changing the basis for the classification of liabilities, for example to take account of management intentions or expectations, could increase the risk of manipulation of the classification and would require reclassifications in both directions. We therefore suggest that the IASB adds this topic to its research agenda.

The interaction with the requirements of IAS 10 *Events after the Reporting Period* would also need to be considered. IAS 10 paragraph 3(a) states that an event is an adjusting event if it provides 'evidence of conditions that existed at the end of the reporting period'. In our view, this could be interpreted on a formal rights or substantive basis, depending on how broadly 'conditions' is defined. However, the consistency of the two standards would need to be reviewed if the basis of the requirements in IAS 1 for the classification of liabilities is amended.

Further clarification on the application of the existing requirements

We welcome the re-ordering of the examples into a more logical structure. However, we believe that there are two specific situations (in addition to the inconsistency in the amended paragraph 69) in which the application of the existing requirements remains unclear, despite the proposed amendments. We suggest that the IASB includes additional examples in IAS 1 alongside the amendments proposed in the ED to clarify how, on a formal rights basis, liabilities should be classified in each of the following situations:

1. *The entity would have been in breach if it was required to test compliance with a covenant at the reporting date*

In some cases, a test of compliance with a covenant is required at a certain date after the reporting date and this test does not result in a breach of the covenant however, the entity would have been in breach *if* the terms of the contract required the entity to perform the test at the reporting date.

Paragraph BC4 states that "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". However, if the condition is not due to be tested until some later date then, in our view, compliance with the condition at the reporting date is irrelevant to classification when the classification is based on formal rights.

2. *The test of compliance is based on information relating to the reporting date that is only available subsequently*

In some cases, covenant conditions are set by reference to information contained in audited annual financial statements. While the information relates to the reporting period it is inevitable that the financial statements will not be available and the test not performed until some point after the reporting date. A very literal interpretation of the requirements

might consider there to have been no breach of the covenant at the reporting date as the test was not and could not have been performed at that date.

In our view, this test is confirming conditions that were in existence at the reporting date and should therefore be treated as an adjusting post-balance sheet event, resulting in the liability being classified as current. However, it is not clear from the redrafted examples in the ED how the IASB intends a liability to be classified in such circumstances.

Clarity on the purpose of the amendments

While the amendments proposed in this ED are intended only to clarify the existing requirements in IAS 1 for the classification of liabilities, there is a risk that preparers may interpret the amendments as a change to the classification requirements. In our view, it is important that the IASB clearly communicates to its constituents that this is not the IASB's intention, to avoid confusion.

For example, the ED substitutes 'right' for 'unconditional right' in paragraph 69(d), which makes it clearer that conditions such as requirements to meet the terms of covenants and continue to make scheduled repayments do not automatically result in a liability being classified as current. However, the removal of the term 'unconditional' may be misinterpreted to imply that a liability should be classified as non-current even when a 'right' is far more uncertain (for example, if it has conditions attached that are not within the entity's control).

Question 2 – Linking settlement with the outflow of resources

The IASB proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding 'by the transfer to the counterparty of cash, equity instruments, other assets or services' to paragraph 69 of the Standard.

Do you agree with that proposal? Why or why not?

Yes, we agree with the proposed link between the settlement of the liability and the outflow of resources from the entity.

We believe that the new sentence inserted at the end of paragraph 69 helps to clarify the difference between 'refinancing' (when an existing liability is extinguished and replaced by a new liability) and 'rolling over' (when an existing liability is extended, and no settlement takes place because there is no outflow of resources).

However, in certain cases this new sentence may be inconsistent with the existing requirement in paragraph 69(d) 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'.

For example, it is unclear how these requirements interact if a liability can be settled, at the option of the lender, either in cash in three years or by transferring equity instruments within twelve months; in such a case paragraph 69(d) requires the liability to be classified as non-

current (because it states that the equity instrument settlement option does not affect the classification of the liability) whereas the new sentence at the end of paragraph 69 would require the liability to be classified as current (because this definition of settlement includes the transfer of equity instruments, the implication of which is that the entity does not have a right to defer settlement for more than twelve months when the lender has an option to require settlement in equity instruments within twelve months).

On review of paragraphs BC38L to BC38P of IAS 1 it appears that the requirement in paragraph 69(d) may have been intended to apply when the counterparty has an option to demand settlement of a component of a compound convertible instrument by issue of a fixed number of the entity's shares, and the new sentence at the end of paragraph 69 may have been intended to refer to settlement by the transfer of a variable number of shares. The interaction of the requirements is unclear from the ED and we request that the IASB clarifies this in the standard.

Question 3 – Transition Arrangements
The IASB proposes that the proposed amendments should be applied retrospectively. Do you agree with that proposal? Why or why not?

Yes, we agree that the proposed amendments should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This will result in consistent presentation of comparative amounts.

We also note that paragraph 41 of IAS 1 already requires an entity to reclassify comparative amounts when making changes to the presentation or classification of items in its financial statements, unless this is impracticable. We do not anticipate that it would be impracticable for entities to reclassify comparative amounts in this case.