Issues Paper
ED/2015/1 *Classification of Liabilities* (Proposed amendments to IAS 1)

Purpose

1 The purpose of this paper is:

(a) Form tentative views on the IASB proposals in IASB ED/2015/1 *Classification of Liabilities* (Proposed amendments to IAS 1);

(b) decide key comments to be raised in the AASB comment letter to the IASB (subject to feedback received from constituents); and

(c) decide on the process for finalising the AASB's comment letter.

2 This paper is structured to correspond to the questions asked by the IASB in ED/2015/1.

Overall preliminary staff views on the proposals

3 AASB staff note that the proposed amendments to IAS 1 *Presentation of Financial Statements* are in response to the need to clarify the classification of liabilities as either current or non-current in order to improve presentation in financial statements. However, AASB staff are concerned that there is an insufficient explanation in the Exposure Draft explaining the IASB's overall objective for the proposals and/or the IASB's intentions regarding many of the proposed amendments.

4 In particular, the key concerns AASB staff recommend to outline in the cover letter to the submission are:

(a) as outlined in paragraphs 8-10 below, the deletion of the term 'unconditional' from paragraph 69(d).

AASB staff note that the Basis for Conclusions states that most loans have conditions, however AASB staff consider the proposed amendment could result in significant divergence of the classification of liabilities and strongly recommend, if the proposed amendment proceeds, the IASB provides clear guidance and examples on what a 'right' is in relation to classification of liabilities.

(b) as outlined in paragraphs 5-6 below, AASB staff consider there is a need for greater clarification of the role that management intentions/expectations play in determining the classification of liabilities. AASB staff are unclear if the IASB's intention to limit the consideration of management expectations to events after the reporting date that have not been substantiated, or is it that management's expectations and intentions should not be considered at all? AASB staff recommend further guidance is provided to clarify this issue.

(c) as outlined in paragraphs 12-14 below, the apparent inconsistency with the proposed requirements in paragraph 69 and the guidance in paragraphs 72R-73R and paragraphs BC7-BC11. AASB staff consider the inconsistency may cause some confusion in the application of the revised classification criteria.

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?

<u>Replacing 'discretion' with 'right'</u>

5 AASB staff agree with the IASB's decision to have consistent wording throughout the Standard and appreciate it is in response to constituent feedback. However, AASB staff are not clear what the IASB's overall objective is in replacing the term 'discretion' with 'right'. AASB staff consider the replacement of the term and the removal of the term from the second sentence in paragraph 72R(a) could be clarified to state that that the classification decision should not consider management expectations and or intentions. If this is the objective of the proposed amendment AASB staff agree with the IASB's decision to not consider management's expectation about what may occur after the end of the reporting period. However, AASB staff consider there may be situations in which management's intentions should be considered in determining the classification of a liability. For example, an entity may have a loan that is due for repayment in five years with no covenant attached. Therefore, the classification of the liability would be non-current. However, if the entity, at the end of the reporting period, has every intention of repaying the loan in six months, and they have noted this in communications to the market, AASB staff consider there may be justification in classifying the liability as current.

6 AASB staff consider there needs to be greater clarification in the Basis for Conclusions explaining the IASB's intentions regarding the proposed amendment in paragraph 72R(a) and what part management expectations and intentions play in determining the classification of a liability. As noted in paragraph 5 above, without clarification regarding the proposed amendments, it is not clear if the IASB's intention was to limit the consideration of management expectations to events after the reporting date that have not been substantiated, or is it that management's expectations and intentions should not be considered at all.

<u>Rights at reporting date</u>

7 AASB staff agree with the IASB's decision to make it explicit in the Standard that only rights in place at the reporting date should affect the classification of a liability.

<u>Deletion of 'unconditional'</u>

8 AASB staff can appreciate the IASB's explanation in the Basis for Conclusion that rights to defer settlement are rarely unconditional. However, AASB staff are concerned, that the removal of the term from paragraph 69(d) has the potential to create

diversity in practice. The level of subjectivity that could be applied increases the risk that reasonable people may reach different conclusions and a number of loans currently and rightly classified as current will be reclassified as non-current with the removal of this limitation.

9 In addition, consistent with the concern outlined in paragraph 8 above, AASB staff consider the proposed amendment may create less clarity of the requirements in IAS 1 *Presentation of Financial Statements* rather than more clarity. For example, the deletion of the word 'unconditional' does not make it clear what a 'right' is. AASB staff consider an 'unconditional right' has a stronger inference than the term 'right'. AASB staff recommend the IASB retain the term 'unconditional right' in paragraph 69(d) and, to retain consistency of terms in the Standard, replace 'discretion' with the term 'unconditional right' in paragraph 72R.

10 However, if the IASB chooses to proceed with the proposed amendment, AASB staff strongly recommend the IASB provide additional guidance and/or examples demonstrating what constitutes a right in the context of classification of a liability.

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?

11 AASB staff appreciate the benefits to entities of the IASB making a clear link between the settlement of a liability and the outflow of resources; however AASB staff does have concerns regarding the proposed amendment.

12 A key concern is the apparent inconsistency with the proposed requirements in paragraph 69 and the guidance in paragraphs 72R-73R and paragraphs BC7-BC11. As outlined below, AASB staff consider the inconsistency may cause some confusion in the application of the revised classification criteria.

13 The additional sentence added to paragraph 69 that notes 'transfer to the counterparty of cash … that results in the extinguishment of the liability' suggests the classification criteria is applied to a liability that exists with a particular counterparty. Therefore, these words suggest the right to defer settlement only refers to rights to defer settlement of a specified liability with a particular counterparty/lender. However, the proposed text in paragraph 72R(a) focuses on 'an existing loan facility' and the IASB outlines in the Basis for Conclusions paragraphs BC9-BC11 their decision not to propose including an explicit requirement that rolled-over lending must be with the same lender with the emphasis being on ensuring it is an existing loan facility. Therefore, based on the decision in the Basis for Conclusions, the text 'to an existing loan facility' can still be interpreted as being a facility with a different lender.

14 AASB staff strongly recommend the IASB provide clarification of the overriding objective of the proposed amendments. Without clarification, the objective of the proposed amendments could be interpreted as either (a) to inform users of financial statements when a specified liability with a particular counterparty is expected to be settled and result in an outflow of resources to settle that specified liability; or (b) to

inform users of financial statements when there is expected to be a (net) outflow of resources from the entity.

In addition, AASB staff think that further guidance is required to explain the intended interaction between the reference to equity instruments in paragraph 69(d) and the additional proposed paragraph in paragraph 69. Currently paragraph 69(d) states settlement by the issue of equity instruments do not affect its classification if it is at the option of the counterparty, whilst the proposed paragraph states 'for the purpose of classification…settlement of a liability refers to the transfer to counterparty of cash, equity instruments…' AASB staff consider this could be interpreted that if settlement by equity is the counterparty decision then it should be ignored in determining classification, however if it is the entity's decision it can be taken into consideration.

Currently, AASB staff does not consider there is sufficient explanation regarding these two paragraphs and would strongly urge the IASB to provide further clarification. Furthermore, AASB staff consider clarification is required regarding the intended relationship between paragraphs 69(a) and 69(d).

15 Currently, paragraph 69(a) appears to imply that if management expects the settle a liability within its normal operating cycle (which it is presumed is intended to mean within 12 months) then the liability should be classified as current. However, paragraph 69(d) notes that only if an entity does not have right at the end of the reporting period to defer settlement should the classification be current. In addition, the basis for conclusion suggests that emphasis should not be placed on management expectations. Therefore, in determining classification of a liability, in accordance with paragraph 69(a) should management take into consideration their expectations or should it look at the rights held by the entity, and if the entity has a right at the end of the reporting period to defer settlement should management classify the liability as non-current?

16 Although there are no proposed amendments for paragraph 69(a), AASB staff recommend the IASB provide clarification of what the intended relationship is between these two paragraphs, and/or clarify that paragraph 69(a) was only to be considered for liabilities such as trade payables.

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?

17 AASB staff agree with the proposed transitional requirements. However, AASB staff question the reasoning provided in paragraph BC19 for the IASB decision to propose retrospective application.

18 Based on explanation of a change in accounting policy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 14(b):

> '…results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows…'

AASB staff consider the application of the proposed amendments, which may result in a reclassification of a liability and therefore would result in financial statements providing reliable and more relevant information, would be more in the nature of a change in accounting policy.

19 Consistent with this reasoning and based on the definition of a change in accounting estimate in IAS 8, paragraph 5, AASB staff does not consider that the proposed amendments would result in an 'adjustment to the carrying amount of an asset or a liability'.

20 Therefore, AASB staff recommend the IASB amend the explanation in the Basis for Conclusion addressing the transitional requirements.

Questions to Board Members:

Q1 Do Board members agree with the comments/concerns noted in paragraphs 3-20 above?

Q2 Are there any further issues that Board members would like raised in the submission?