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Classification of liabilities

Do the proposed clarifications to IAS 1 hit the mark?

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IN THE HEADLINES

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The need for clearer guidance

Under IFRS, most companies present a balance sheet that classifies liabilities as either current or non-current. This split has traditionally been helpful in understanding a company's ability to meet its liabilities in the short term, although the introduction of enhanced disclosure of maturity and liquidity risk has reduced its relevance.

Even so, companies and users have long struggled with the application of these classification requirements, particularly for loans. It has become a very emotive issue because of the inconsistency between existing requirements, which has caused much debate and confusion in practice.

It is therefore welcome that the IASB is reconsidering this area of IFRS, through its exposure draft[1] issued on 10 February 2015.

Key proposals

The proposals confirm that the classification as current/non-current is based on facts and circumstances at the reporting date, and that the probability of continuing to meet conditions is irrelevant – this has been the case since the IASB amended the requirements in 2003 and is straightforward to apply to, for example, breaches of covenants.

However, potential confusion remains with the proposals to modify the existing classification criteria. At present, IFRS requires that two criteria must *both* be met to classify a liability as non-current:

- the liability must not be due to be settled within 12 months after the reporting period; and
- the company must have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

The proposals delete the word 'unconditional' from the second criterion – i.e. the company must now merely have a 'right' at the end of the reporting period to defer settlement for at least 12 months in order to classify the liability as non-current (assuming that the other criteria are met). Furthermore, references to 'discretion' are replaced by reference to a 'right' in referring to rollover.

These changes have the potential to create diversity in practice, such that reasonable people may reach different conclusions for the same fact patterns.

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

Continued confusion

The potential confusion can be illustrated in the following example, which contrasts:

- a long-term loan that contains conditions – i.e. covenants; and
- a short-term loan that can be rolled over only if the same conditions are met at the date of rollover.

Assume that a company with a year end of 31 December has two liabilities, as follows.

Example	Term loan of 1 million	Rollover facility of 1 million
Fact pattern	• Five-year term loan, fully drawn down • Term loan drawn down at 1 October 20X5, with a due date of 30 September 20Y0 • Annual covenant test* based on information at 30 September that renders the loan repayable on demand if breached	• Five-year facility, fully drawn down • One-year loan drawn down at 1 October 20X5, with intent to roll over on 1 October 20X6 • Ability to roll over loan is conditional on compliance with the same covenant test* as the term loan
Analysis (assessment made at year end 31 December 20X5)	**Under existing and proposed requirements** Both criteria are met at the reporting date. The loan is not due for settlement in less than 12 months, either in accordance with its maturity or because of breaches that exist at the reporting date. The existence or probability of breaches after the reporting date are irrelevant. Therefore, the term loan is classified as non-current.	**Under existing requirements** At the reporting date, the rollover facility gives the company a right to avoid repayment only if it meets certain conditions at a date in the future. In other words, under an existing criterion[2], it is conditional and, arguably, current. **Under proposed requirements** At the reporting date, the company has the right to roll over the facility at a future date. This right is conditional on compliance with covenants at a future date. However, under the proposed requirements, it may appear sufficient that the company has a right – conditional or otherwise – to justify classification as non-current. One may believe that the classification of the two liabilities should be the same, as they are economically similar: the uncertain future compliance with the conditions in the rollover facility is in essence the same as the continued uncertain future compliance with the covenants in the term loan. Accordingly, one may consider that the changes proposed by the IASB – notably to delete the word 'unconditional' – achieve this, and that in the future the amount drawn down under the rollover facility will be classified as non-current. As we discuss in this publication, others may read the proposals differently.

* Assume that the ability to satisfy the covenants is not wholly within the company's control.

2. Paragraph 69(d) of IAS 1 *Presentation of Financial Statements*.

When is a right not quite a right?

The conclusion in the example to classify the rollover facility as non-current may feel appropriate because of the analogy to an economically equivalent term loan. But as there may be an alternative view, it prompts the question: when is a right not quite a right?

For example, should the borrowing still be classified as non-current if the 'right' is conditional on meeting some other future financial test, or on the condition that there are no 'material adverse changes' in the prospective borrower's financial position? These are both common scenarios. Or, what if the 'right' amounted to little more than a right to apply for a loan at a future date, to be considered consistent with the bank's lending criteria?

These are all 'rights', albeit with future conditions, none of which are breached at the reporting date, but all of which are fundamental to whether the company will be able to exercise any right to roll over the facility in the future. Ultimately, a question arises as to whether a 'right' that you can't exercise until a future date, which is based on conditions that are uncertain to be met at that date, is in fact a right at all.

At present, the company also has to have 'discretion' to roll over the loan – can you have discretion if you need the bank's permission at a future date? The IASB proposes to replace that test with a requirement that the company need only have a 'right'.

So, the risk is that the IASB's proposal to delete the word 'unconditional' and refer only to the existence of a 'right' will simply raise a new problem: when is a right not quite a right? Unless clarified, significant diversity in practice may result, risking a new expectation gap between preparers and users.

Need for a broader rethink?

To produce a more intuitive, consistently applied standard, the IASB could perhaps address a number of other practical problems, rather than focusing on a single issue. Examples include:

- why periods of grace are linked to the rectification of breaches (paragraph 75 of IAS 1);
- how to classify derivatives as current or non-current; and
- how to estimate the current portion of a long-term loan.

But if the IASB pursues a clarification of this relatively narrow issue, then we would welcome a clarification as to what is meant by a 'right'; preparers and users would then know what the requirement means and users could not misinterpret a company's rights as more than they are.

In addition, we suggest that the IASB might go further and ask users whether a current/non-current classification continues to be relevant given that separate disclosures now exist on liquidity risk and contractual maturity, and then put forward proposals that respond to users' needs.

Next steps

The IASB has requested comments from all stakeholders. The comment period is open until 10 June 2015.

Find out more

For more information, read the IASB press release or speak to your usual KPMG contact.

"We are concerned that the proposals may not bring clarity, and so might risk continued diversity in practice. A broader rethink may be needed."

– David Littleford,
KPMG's global IFRS presentation leader

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