EFRAG's Draft Letter to the European Commission Regarding Endorsement of Classification of Liabilities as Current or Non-current, Amendments to IAS 1 *Presentation of Financial Statements*

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European Commission
1049 Brussels

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Dear Mr Berrigan,

When finalised, the signed final endorsement advice shall be sent by e-mail to the European Commission (before publishing the letter on our website and releasing the news item, to the responsible persons from the DG-FISMA. Please confirm these contacts with EFRAG's Project Director.

Endorsement of Classification of Liabilities as Current or Non-current

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of International Accounting Standards, EFRAG is pleased to provide its opinion on the Classification of Liabilities as Current or Non-current, Amendments to IAS 1 *Presentation of Financial Statements* ('the Amendments,'), which were issued by the IASB on 23 January 2020. An Exposure Draft of the Amendments were issued on 10 February 2015. EFRAG provided its comment letter on that Exposure Draft on 22 June 2015.

The objectives of the Amendments are to clarify the requirements in IAS 1 on classification of liabilities and remove some inconsistencies in the terms used in the Standard.

The Amendments shall be applied retrospectively for annual periods beginning on or after 1 January 2022, with earlier application permitted. If entities apply the Amendments earlier, they shall disclose that fact. A description of the Amendments is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and raised no issues regarding prudent accounting.

EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

In EFRAG's assessment of whether the Amendments would be conducive to the European public good, EFRAG has assessed whether the Amendments would improve financial reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendments could affect economic growth.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raise no issues regarding prudent accounting and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement without further delay.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 Paragraph 69 of IAS 1 *Presentation of Financial Statements* requires an entity to classify a liability as current if the entity 'does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period'. Paragraph 73 requires an entity to classify a liability as non-current if 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'.

2 The IFRS Interpretations Committee received two requests for guidance on the relationship between these two requirements. The Committee proposed new guidance as part of the *Annual Improvements to IFRSs 2010–2012 Cycle* but, after considering feedback from respondents, decided not to recommend finalising the guidance. At its March 2013 meeting the IASB accepted that recommendation and decided to reconsider the issue.

3 At its meeting in September 2013, the IASB tentatively decided to develop clarifications applying a principle that the classification of a liability as current or non-current should reflect the rights existing at the end of the reporting period. In February 2015, the IASB published its proposals in the Exposure Draft *Classification of Liabilities*.

4 On 24 September 2019 the IASB met to finalise the Amendments and decided:

(a) not to re-expose the amendments; and

(b) that the amendments should apply for annual reporting periods beginning on or after 1 January 2022.

5 On 23 January 2020 the IASB issued the Amendments.

The issue and how it has been addressed

6 IAS 1 requires a company to classify a liability as current unless, among other things, the company has an unconditional right to defer settlement of the liability for at least twelve months. Sometimes preparers of financial statements find it difficult to interpret this requirement. As a result, entities classify similar liabilities differently, making it hard for investors to understand and compare the financial positions of different entities.

7 To remedy this issue, the Amendments aim to promote consistency in applying the requirements by helping companies determine whether, in the statement of financial position, debt and other liabilities with an uncertain settlement date should be classified as current (due or potentially due to be settled within one year) or non-current. The amendments include clarifying the classification requirements for debt a company might settle by converting it into equity.

8 The amendments clarify, not change, existing requirements, and so are not expected to affect companies' financial statements significantly. However, they could result in companies reclassifying some liabilities from current to non-current, and vice versa; this could affect a company's loan covenants. Thus, to give companies time to prepare for the amendments, the Board has set the effective date at January 2022. Early application of the amendments is permitted.

What has changed?

9 The Amendments clarify one of the criteria in IAS 1 for classifying a liability as non-current - that is, the requirement for an entity to have the right to defer settlement of

the liability for at least 12 months after the reporting period (IAS 1.69(d) and example in IAS 1.73). The Amendments include:

(a) specifying within the classification principle that an entity's right to defer settlement must exist at the end of the reporting period;

(b) deleting the word "unconditional" from the classification principle as the rights are often conditional on compliance with covenants and instead adding a paragraph (IAS 1.72A) to clarify that if an entity`s right to defer settlement is subject to compliance with specified conditions;

(c) adjusting the example in IAS 1.73, to align the example and the classification principle and to align the terminology used; and

(d) clarifying that classification is unaffected by management's intentions or expectations about whether the entity will exercise its right to defer settlement;

(e) clarifying when a liability is settled; and

(f) clarifying requirements for classifying liabilities an entity will or may settle by issuing its own equity instruments (in other words, by converting the liability to equity) by moving the statement about counterparty conversion options from IAS 1.69(d) to a new paragraph and clarifying scope.

10 Finally, it proposes that retrospective application should be required, and that early application should be permitted.

When do the Amendments become effective?

11 An entity shall apply the Amendments for annual periods beginning on or after 1 January 2022 retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

Appendix 2: EFRAG's technical assessment on the Classification of Liabilities as Current or Non-current against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its*

application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive' (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS Standards and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 7 to 9;

(b) reliability: paragraphs 10 to 12;

(c) comparability: paragraphs 13 to 15;

(d) understandability: paragraphs 16 to 18;

(e) whether overall, they lead to prudent accounting: paragraphs 19 to 20; and

(f) whether they would not be contrary to the true and fair view principle as noted in paragraphs 21 to 24.

Relevance

7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

8 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

9 EFRAG notes that liquidity ratios are widely used in analysing financial statements, therefore the classification between current and non-current is important. As the Amendments provides more clarity on how to make the distinction between the current and non-current classification it is assessed to increase relevance.

Reliability

10 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

11 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

12 EFRAG acknowledges that the Amendments brings about faithful presentation for the classification of liabilities as it removes the inconsistencies in the terms used in

paragraph 73 and paragraph 63 of IAS 1. Therefore, EFRAG assesses that it could enhance reliability.

Comparability

13 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

14 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

15 EFRAG acknowledges that without the Amendments preparers of financial statements sometimes find it difficult to interpret the requirement of having an '*unconditional right to defer settlement of the liability for at least twelve months*'. This resulted in entities classifying similar liabilities differently, making it hard for investors to understand and compare the financial positions of different entities. EFRAG assesses that the Amendments clarify the appropriate treatment and, thus, contribute to comparability of the resulting information.

Understandability

16 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

17 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

18 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendment is understandable, is whether that information will be unduly complex. EFRAG acknowledges that sometimes preparers of financial statements find it difficult to interpret when they have an '*unconditional right to defer settlement of the liability for at least twelve months*'. Therefore, EFRAG assesses that the clarity provided by the Amendments could increase understandability.

Prudence

19 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated, and liabilities or expenses are not understated.

20 EFRAG did not identify any aspects of the Amendments that would affect prudence.

True and Fair View Principle

21 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

22 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards and are designed to complement IAS 1. Accordingly,

EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

23 EFRAG has concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.

24 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

25 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are designed to clarify specific aspects of the guidance on how to classify debt and other liabilities as current or non-current.

4 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

5 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, as they are narrow in scope, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

6 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

7 The Amendments should be applied retrospectively. However, the Amendments clarify, not change, existing requirements. Therefore, some entities may already be applying IAS 1 in a way that is identical or very similar to that required by the Amendments, and for those entities it is likely that there will be little if any incremental cost involved.

8 Overall, EFRAG's assessment is that the Amendments will not result in increased costs to preparers, i.e., it is likely to be cost neutral.

Costs for users

9 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

10 The Amendments aim to promote consistency in applying the requirements by helping entities determine whether, in the statement of financial position, debt and other liabilities with an uncertain settlement date should be classified as current (due or potentially due to be settled within one year) or non-current .

11 Overall, EFRAG's assessment is that implementation of the Amendments will not result in increased costs to users; that is, it is likely to be cost neutral.

Benefits for preparers and users

12 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

13 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments, as the information resulting from it will remove inconsistency and increase comparability between entities and therefore will enhance their analysis.

Conclusion on the costs and benefits of the Amendments

14 EFRAG's overall assessment is that the overall benefits of enhanced consistency of application and increased comparability are likely to outweigh costs associated with complying with the Amendments.

Conclusion

15 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

16 EFRAG has not identified the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

17 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.

18 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.