

AMENDMENTS TO IAS 1 - CLARIFICATION OF THE MEANING OF 'SETTLEMENT' IN THE CLASSIFICATION OF LIABILITIES

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Background

In January 2020, the IASB issued amendments to IAS 1 - Classification of Liabilities as Current or Non-current (the 2020 Amendments). One of the requirements prescribed by the 2020 Amendments related to the classification of liabilities subject to covenants. Due to several concerns raised about the outcome of these requirements, in October 2022, the IASB issued further amendments to IAS 1 - Non-current Liabilities with Covenants (the 2022 Amendments). The 2022 Amendments specified how covenants included in a loan arrangement affect whether the entity (the borrower) has a right to defer settlement of the liability arising from the loan arrangement for at least twelve months after the reporting period.

BDO released IFRS Accounting Standards In Practice - IAS 1 Classification of Loans as Current or Non-current that covers, in detail, the cumulative effect of the 2020 Amendments and the 2022 Amendments related to the right to defer settlement of liabilities in the context of covenants included in loan arrangements.

In the 2020 Amendments, the IASB also clarified the meaning of 'settlement' for the purpose of classifying a liability as current or non-current. These clarificatory requirements were not subsequently modified by the 2022 Amendments. The 2020 Amendments and the 2022 Amendments are applicable for annual reporting periods beginning on or after 1 January 2024.

In this IFRB Bulletin, we analyse the requirements of the 2020 Amendments related to the meaning of 'settlement' (referred to as 'the Amendments' hereafter) and how these amendments may significantly change how certain liabilities have historically been classified, including many convertible debt instruments.

Status
Final

Effective date
Annual reporting periods
beginning on or after 1
January 2024

Accounting impact
The Amendments may
have a significant effect
on the classification of
liabilities as current or
non-current, particularly
in case of hybrid
financial instruments
(e.g. convertible debt),
with American-style
conversion options.

The Amendments

What led to the Amendments?

Prior to the 2020 Amendments, IAS 1.69 included the following requirements related to settlement of a liability (**emphasis added**):

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.***

There were primarily two aspects of the requirements that the IASB intended to clarify, as below:

1. Clarification on the meaning of settlement:

While developing the 2020 Amendments, the IASB considered the question of whether a liability is 'settled' when it is rolled over under an existing loan facility. As noted by the IASB in Basis for Conclusions to the 2020 Amendments (BC48F), it concluded that rolling over a liability does not constitute settlement because it is the extension of an existing liability, which does not involve any transfer of economic resources. The IASB also observed that a liability is defined as an obligation 'to transfer an economic resource' and that some types of liabilities are settled by transferring economic resources other than cash.

Therefore, the IASB decided that it would be helpful to clarify those aspects of the meaning of the term 'settlement'. As a result, paragraph 76A was added to IAS 1 *Presentation of Financial Statements*.

2. Liabilities that an entity will or may settle by issuing its own equity instruments:

Prior to the 2020 Amendments, IAS 1.69(d) required that the 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. As a result, a bond that the holder may convert to equity before maturity was classified as current or non-current according to the terms of the bond, without considering the possibility of earlier settlement by conversion to equity.

As noted by the IASB in Basis for Conclusions to the 2020 Amendments (BC48H), the IASB had intended the statement to apply only to liabilities that included a counterparty conversion option that met the definition of an equity instrument and, applying IAS 32 *Financial Instruments: Presentation*, was recognised separately from the host liability as the equity component of a compound financial instrument. The IASB further concluded that, in other cases - that is, if an obligation to transfer equity instruments is classified applying IAS 32 as a liability or part of a liability - the transfer of equity instruments would constitute settlement of the liability for the purpose of classifying it as current or non-current.

However, prior to the Amendments, there was diversity in interpretation of paragraph 69(d). One of the interpretations was that a conversion option that was classified as a derivative liability would be settled by issue of shares, which are equity instruments and as a result, the settlement terms of the conversion option were considered not to affect the classification of the host liability as current or non-current. Therefore, the IASB decided to move the statement about counterparty conversion options from paragraph 69(d) to new paragraph 76B and clarify its scope.

The Amendments

The Amendments amended paragraphs 69(d) and introduced new paragraphs 76A and 76B.

IAS 1.69(d) (new text is underlined and deleted text is struck through)

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 the an-unconditional right at the end of the reporting period 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.~~

IAS 1.76A

For the purpose of classifying a liability as current or non-current, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of:

- (a) cash or other economic resources—for example, goods or services; or*
- (b) the entity’s own equity instruments, unless paragraph 76B applies.*

IAS 1.76B

Terms of a liability that could, at the option of the counterparty, result in its settlement by the transfer of the entity’s own equity instruments do not affect its classification as current or non-current if, applying IAS 32 Financial Instruments: Presentation, the entity classifies the option as an equity instrument, recognising it separately from the liability as an equity component of a compound financial instrument.

Thus, IAS 1.76B is essentially a condition where, if specified criteria are met for the manner in which a liability may be settled, that settlement mechanism is disregarded for purposes of classifying a liability.

The following tables explain the effect of IAS 1.76B on the classification of a liability as current or non-current for financial instruments with conversion options:

Compound financial instrument		
	<i>Liability component</i>	<i>Equity component (conversion option classified as equity)</i>
<i>Prior to the Amendments</i>	Classification as current/ non-current not affected by the settlement terms of the conversion option, which is classified as equity.	Not classified as current or non-current, being equity.
<i>After the Amendments</i>	Classification solely based on the settlement terms of the liability component.	

Hybrid financial instrument		
	<i>Host liability component</i>	<i>Derivative liability component (conversion option classified as a derivative liability)</i>
<i>Prior to the Amendments</i>	<p>Diversity in practice. Approaches followed:</p> <ol style="list-style-type: none"> 1. Classification as current/ non-current not affected by the settlement terms of the conversion option, which is classified as a derivative liability. Classification solely based on the settlement terms of the liability component. 2. Classification as current/ non-current affected by the settlement terms of the conversion option, which is classified as a derivative liability. 	<p>Classified as current or non-current on the basis of the terms of exercise of the derivative.</p> <p>Another approach followed by some entities was to apply a similar interpretation as in Approach 1 for the liability component. Under this approach, since the shares issued for the settlement of the derivative are equity instruments, these settlement terms were disregarded. The derivative was classified as current or non-current on the basis of its maturity date. This approach primarily affected the classification as current or non-current for American-style conversion options.</p>
<i>After the Amendments</i>	<p>Classification as current/ non-current affected by the settlement terms of the conversion option, which is classified as a derivative.</p>	<p>Classified as current or non-current on the basis of the terms of exercise of the derivative.</p>

The Amendments primarily affect the classification as current or non-current for host liabilities with American style conversion options that are classified as derivative liabilities.

American style conversion options give a right to the holder to exercise the option any time up to its maturity date, as opposed to European style conversion options which may be exercised only on maturity.

If a conversion option is classified as a derivative liability, that conversion is considered to be settlement of the host liability and if the option may be exercised any time before the maturity of the liability (i.e. it is an American style option), the entity does not have the right to defer settlement of the liability for at least twelve months after the end of the reporting period. As a result, the host liability is classified as current, which prior to the Amendments, following Approach 1, may have been classified as non-current, if its maturity was after 12 months from the end of the reporting period.



Illustrations

Example 1 - Convertible debt with conversion feature classified as equity

Entity A issues a CU (currency unit) 100 note payable with an ‘American style’ conversion option, exercisable at the option of the holder at any time over the life of the note. Interest is payable at 10% annually in arrears. If exercised, the conversion feature will result in the principal amount of the note being converted into 10 common shares of Entity A together with cash settlement of any accrued but unpaid interest. Otherwise, the note payable is repayable, plus interest, in 5 years. CU is the functional currency of Entity A.

Analysis:

The note is a compound financial instrument containing a financial liability (the note payable plus interest) and an equity instrument (the conversion feature). The conversion feature is an equity instrument because there is no obligation to pay cash and the conversion feature will result in a fixed amount of cash (the note) being exchanged for a fixed number of shares (i.e. the ‘fixed for fixed’ test in IAS 32 is met).

The components of the compound financial instrument are classified as follows:

COMPONENT	CLASSIFICATION & RATIONALE	
	PRIOR TO THE AMENDMENTS	AFTER THE AMENDMENTS
Financial liability - note payable (principal amount)	<p>Non-current</p> <p>Applying IAS 1.69(d), as applicable prior to the Amendments, the conversion feature, which could result in the settlement of the liability by the issue of equity instruments <i>does not affect</i> its classification.</p> <p>The principal and accrued interest are not due for 5 years, therefore, Entity A has the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Non-current</p> <p>Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, <i>does not affect</i> the note’s classification as current or non-current because the conversion feature is classified as an equity instrument.</p> <p>The principal and accrued interest are not due for 5 years, therefore, Entity A has the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>
Financial liability - accrued but unpaid interest	<p>Current</p> <p>Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Current</p> <p>Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>
Equity component - conversion feature	<p>N/A - equity</p> <p>Equity is not classified as current or non-current.</p>	<p>N/A - equity</p> <p>Equity is not classified as current or non-current.</p>

Example 2 - Convertible debt with conversion feature classified as derivative financial liability

Example 2 is identical to Example 1, except for the section underlined and in italics.

Entity A issues a CU (currency unit) 100 note payable with an ‘American style’ conversion option, exercisable at the option of the holder at any time over the life of the note. Interest is payable at 10% annually in arrears. If exercised, the conversion feature will result in the principal amount of the note being converted into 10 common shares of Entity A together with cash settlement of any accrued but unpaid interest. Otherwise, the note payable is repayable, plus interest, in 5 years. CU is not the functional currency of Entity A; its functional currency is FU (‘foreign units’).

Analysis:

The note is a hybrid financial instrument containing a financial liability (the note payable plus interest) and a derivative financial liability (the conversion feature). The conversion feature is a derivative financial liability because, despite there being no obligation to pay cash, the conversion feature does not meet the ‘fixed for fixed’ criteria in IAS 32, as the note payable is denominated in a currency other than Entity A’s functional currency. Therefore, the amount of cash that will be required to settle the liability on conversion is not represented by a fixed amount of cash expressed in Entity A’s functional currency. That is to say, the note that may be settled by the exercising of the conversion feature is fixed in terms of CU, but not FU, the functional currency of Entity A.

The components of the hybrid financial instrument are classified as follows:

COMPONENT	CLASSIFICATION & RATIONALE		
	PRIOR TO THE AMENDMENTS		AFTER THE AMENDMENTS
	Approach 1	Approach 2	
Financial liability - note payable (principal amount)	<p>Non-current</p> <p>IAS 1.69(d), as applicable prior to the Amendments, is interpreted to mean that the shares that would be issued upon the exercise of the conversion feature are equity instruments. Therefore, this settlement feature <u>does not affect</u> the classification of the liability.</p> <p>As the principal is not due for 5 years, Entity A has the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)). Therefore, the liability is classified as non-current.</p>	<p>Current</p> <p>IAS 1.69(d), as applicable prior to the Amendments, is interpreted to mean that the conversion feature <u>does affect</u> the classification of the liability, as it is classified as a derivative liability and not equity.</p> <p>Exercise of the conversion option is considered to be settlement of the host liability.</p> <p>As the conversion option is an American-style option, convertible any time prior to maturity, the entity does not have the right to defer settlement of the host liability for at least twelve months after the reporting period and the host liability is classified as current (IAS 1.69(d)).</p>	<p>Current</p> <p>Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, <u>does affect</u> the note’s classification as current or non-current because the conversion feature is not classified as an equity instrument.</p> <p>Exercise of the conversion option is considered to be settlement of the host liability.</p> <p>As the conversion option is an American-style option, convertible any time prior to maturity, the entity does not have the right to defer settlement of the host liability for at least twelve months after the reporting period and the host liability is classified as current (IAS 1.69(d)).</p>

COMPONENT	CLASSIFICATION & RATIONALE <i>(continued)</i>		
	PRIOR TO THE AMENDMENTS		AFTER THE AMENDMENTS
	Approach 1	Approach 2	
Financial liability - accrued but unpaid interest	<p>Current</p> <p>Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Current</p> <p>Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Current</p> <p>Accrued but unpaid interest is not convertible into shares, therefore, its classification is unaffected by the conversion feature. Interest is payable annually in arrears, therefore, Entity A does not have the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>
Derivative financial liability - conversion feature	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p> <p><i>(In some cases, an alternate approach was followed under which settlement of the derivative by issue of shares, being equity instruments, was disregarded. The derivative was classified as current or non-current on the basis of its maturity date. In this fact pattern, as the maturity of the derivative is after 5 years, it is classified as non-current.)</i></p>	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>

Example 3 - Convertible debt with conversion feature classified as derivative financial liability

Entity A issues a CU (currency unit) 100 note payable with an ‘American style’ conversion option, exercisable at the option of the holder at any time over the life of the note. The note carries an annual coupon at SONIA + 200 bps. The coupon ‘rolls up’ and is added to the amount repayable on maturity of the loan after 5 years. However, at any point, the carrying amount of the liability (i.e. unpaid principal and interest) is convertible into 10 common shares of Entity A. CU is the functional currency of Entity A.

Analysis:

The note is a hybrid financial instrument containing a financial liability (the note payable plus interest) and a derivative financial liability (the conversion feature). The conversion feature is not classified as equity because it fails the ‘fixed for fixed’ test. This is because exercising the conversion feature will result in a variable amount of cash (unpaid principal plus accrued interest at a floating interest rate, which will vary over the term of the note) being converted into a fixed number of shares. The conversion feature introduces the possibility that the loan may be settled by the exchange of a variable amount of an obligation to pay cash for a fixed number of shares, which is not an equity instrument.

The components of the hybrid financial instrument are classified as follows:

COMPONENT	CLASSIFICATION & RATIONALE		
	PRIOR TO THE AMENDMENTS		AFTER THE AMENDMENTS
	Approach 1	Approach 2	
Financial liability - note payable (principal amount)	<p>Non-current</p> <p>IAS 1.69(d), as applicable prior to the Amendments, is interpreted to mean that the shares that would be issued upon the exercise of the conversion feature are equity instruments. Therefore, this settlement feature <u>does not affect</u> the classification of the liability.</p> <p>As the principal and accrued interest are not due for 5 years, Entity A has the right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)). Therefore, the liability (principal plus accrued interest) is classified as non-current.</p>	<p>Current</p> <p>IAS 1.69(d), as applicable prior to the Amendments, is interpreted to mean that the conversion feature <u>does affect</u> the classification of the liability as it is classified as a derivative liability and not equity.</p> <p>Exercise of the conversion option is considered to be settlement of the host liability (principal plus accrued interest).</p> <p>As the conversion option is an American-style option, convertible any time prior to maturity, the entity does not have the right to defer settlement of the host liability for at least twelve months after the reporting period and the host liability is classified as current (IAS 1.69(d)).</p>	<p>Current</p> <p>Applying IAS 1.76B, the conversion feature, which may be exercised by the holder at any time, <u>does affect</u> the note’s classification as current or non-current because the conversion feature is not classified as an equity instrument.</p> <p>Exercise of the conversion option is considered to be settlement of the liability (principal plus accrued interest).</p> <p>As the conversion option is an American-style option, convertible any time prior to maturity, the entity does not have the right to defer settlement of the host liability for at least twelve months after the reporting period and the host liability is classified as current (IAS 1.69(d)).</p>
Financial liability - accrued but unpaid interest			

COMPONENT	CLASSIFICATION & RATIONALE <i>(continued)</i>		
	PRIOR TO THE AMENDMENTS		AFTER THE AMENDMENTS
	Approach 1	Approach 2	
Derivative financial liability - conversion feature	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p> <p><i>(In some cases, an alternate approach was followed under which settlement of the derivative by issue of shares, being equity instruments, was disregarded. The derivative was classified as current or non-current on the basis of its maturity date. In this fact pattern, as the maturity of the derivative is after 5 years, it is classified as non-current.)</i></p>	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>	<p>Current</p> <p>The conversion feature may be exercised by the holder at any time, and therefore, Entity A does not have the right to defer its settlement for at least twelve months after the reporting period (IAS 1.69(d)).</p>

Effect of the Amendments in case of European style options

The Amendments are not expected to significantly affect liabilities with conversion options, where the option is a European style option. In case of European style options, if the host liability is due for repayment after twelve months from the end of the reporting period and the conversion option also has an exercise date after twelve months from the end of the reporting period, considering the exercise of the option as settlement of the liability will still result in the classification of the liability as non-current.

Effective date

The Amendments are effective for annual reporting periods beginning on or after 1 January 2024 retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies the 2022 Amendments for an earlier period, it shall also apply the 2020 Amendments for that period.

Restatement of comparatives

The Amendments are effective retrospectively. Therefore, an entity would be required to restate the comparatives if the classification of any liability as current or non-current is changed as a result of the Amendments for the comparative period.

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