European Securities and Markets Authority

The Chair

Date: 3 June 2015
ESMA/2015/912

Mr Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Ref: The IASB's Exposure Draft *Classification of Liabilities*: Proposed amendments to IAS 1

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process regarding the Exposure Draft (ED) *Classification of Liabilities*: Proposed amendments to IAS 1 *Presentation of Financial Statements*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

ESMA welcomes this long-awaited proposed clarification that is expected to address some of the existing diversity in practice, notably in the area of classification of liabilities with roll-over options. While ESMA supports the proposals in the ED that are based on the entity's rights at the end of the reporting period, it is of the view that there is a need to further improve the requirements on classification of liabilities as either current or non-current when rights in place at the reporting date are subject to a condition.

Furthermore, ESMA encourages the IASB to address explicitly, as part of this amendment, the criteria for classification of liabilities with uncertain timing (e.g. warranty provisions) as current or non-current.

Our detailed comments on the ED are set out in the Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor

Appendix I – ESMA's detailed answers to the questions in the ED

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?

1. ESMA supports the proposed amendments and welcomes the clarification addressing the existing diversity in practice, notably in the area of classification of liabilities with roll-over options. We are of the view that the explicit reference to the rights in place at the reporting date that affect classification of a liability should result in greater consistency in application of the principles of IAS 1. While ESMA agrees that the proposed deletion of the reference to 'an unconditional right' and 'discretion' and replacing it with '(a) right' would not change the existing principles in IAS 1, ESMA recommends the IASB to evaluate the possible effects of replacement of these terms on a wide range of financial and non-financial liabilities with different economic characteristics.

2. In addition, we suggest that the standard is more explicit on cases where rights in place at the reporting date are subject to a condition. ESMA agrees with the explanation in paragraph BC 4 of the proposed amendments which states that '*when a right is subject to a condition, 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*'. ESMA is of the view that this explanation further clarifies the principle of the amendment and should become part of the body of the standard. However, as stated in paragraphs 3 – 6 of this letter ESMA urges the IASB to provide further guidance on the assessment whether an entity complies with the condition as at the end of the reporting period.

   Assessment of the condition at the end of the reporting period

3. We are of the view that in some circumstances such assessment is not straightforward. This is the case, for example in the situation where the covenants of the loan are calculated with reference to a date after the end of the reporting period (e.g. financial data as of 30 June of the following period) but the entity's calculation based on financial data as at the reporting date (31 December) shows that it would breach the covenant if the testing of covenants was based on the financial data as at the end of the reporting period.

ESMA considers that in this set of circumstances, two views leading to divergent application might occur.

4. One possible view would lead to a ‘current’ classification of these liabilities, as the assessment at the reporting date indicates that the entity does not comply with the condition as at the end of the reporting period. If that is the intention, ESMA urges the IASB to clarify how this principle could be applied in situations where an entity, with a liability subject to different conditions, faces changes in its financial situation (e.g. improved financial position) or contractually different covenants during the 12 months after the end of the reporting period. Furthermore, application of this principle in interim financial statements would need to be clarified in light of possible seasonality or other changes.

5. Another possible view would lead to a 'non-current' classification of these liabilities, as the entity is contractually required to comply with the condition only at a date after the end of the reporting period and could potentially remedy the breach before that date (e.g. by a waiver from the lender).

6. ESMA considers that the assessment as to whether the entity complies with the condition as at the end of the reporting period should be based on a clear principle that does not automatically lead to a classification of a liability as current at the year-end whereas the covenants might in fact not be breached at the calculation date.

Assessment of the condition that is dependent on the unilateral decision of the lender

7. Furthermore, ESMA encourages the IASB to provide further guidance on assessment of the condition that is solely dependent on the unilateral decision of the counterparty. We are of the view that the IASB should clarify the application of the amendments in the situation where the lender has the unilateral right to request early repayment of a long-term loan (i.e. loan with remaining maturity exceeding 12 months) at specific dates within the 12 months period after the reporting date subject to a short notice period. In such circumstances the debtor has a right to defer settlement for at least 12 months conditional upon lender’s decision.

Classification of liabilities with uncertain timing

8. Finally, ESMA also encourages the IASB to address explicitly, as part of this amendment, the classification of liabilities with uncertain timing (e.g. warranty provisions that meet the definition of non-financial liability). Based on the experience of European enforcers, most entities in Europe classify the part of warranty provisions that are not expected to be used or claimed within one year after the reporting date as 'non-current' even if they do not have the right to defer the settlement (in circumstances where they do not fulfil other criteria of paragraph 69 of IAS 1). While ESMA agrees that management expectations should not be taken into account when classifying financial liabilities, we note that, in practice, they are often taken into account when classifying provisions whose timing is uncertain.

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?

9. ESMA agrees with this proposal as it makes explicit the link between the settlement of the liability and the outflow of resources and thus helps to clarify some existing classification issues, such as roll-over of a debt.

Question 3 - Transition provisions

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

10. ESMA agrees with the proposed transition requirements.