IASB ISSUES EXPOSURE DRAFT TO AMEND IAS 1 - NON-CURRENT LIABILITIES WITH COVENANTS

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BACKGROUND

In January 2020, the IASB issued *Amendments to IAS 1 – Classification of Liabilities as Current or Non-current*. These amendments (the '2020 amendments') introduced new requirements for how an entity determines whether a liability (e.g. bank loan, lease liability) is presented as current or non-current. The 2020 amendments were originally mandatorily effective for annual reporting periods beginning on or after 1 January 2022. BDO published an IFR Bulletin summarising these amendments, which may be accessed here. Due to the effects of COVID-19, the IASB subsequently amended the effective date to 1 January 2023.

Subsequent to the publishing of the 2020 amendments, concerns were raised by stakeholders that the outcome of applying these amendments might result in unintended consequences. Some stakeholders also believed that the application of the amendments might impair the usefulness of financial information.

In April 2021, these concerns were raised with the IFRS Interpretations Committee, which was asked to confirm the outcome of applying the 2020 amendments to example fact patterns. The Interpretations Committee ultimately decided not to finalise the tentative agenda decision relating to the submission and referred the matter to the IASB.

In response to these concerns, in mid-2021, the IASB added a project to its work plan to explore potential standard setting. In November 2021, the IASB issued an exposure draft to modify the 2020 amendments – *Non-Current Liabilities with Covenants.*

This publication summarises the effects of the 2020 amendments, the concerns raised by stakeholders and the proposals contained in the November 2021 exposure draft.

STATUS
Exposure draft

EFFECTIVE DATE
Proposals would be mandatorily effective for annual reporting periods beginning on or after a date to be decided after exposure, but no earlier than 1 January 2024, with earlier application permitted.

ACCOUNTING IMPACT
Modify the requirements introduced by *Classification of Liabilities as Current or Non-Current* (2020 amendments) on how an entity classifies financial liabilities, as well as introducing new presentation and disclosure requirements.

THE 2020 AMENDMENTS

WHAT DID THE 2020 AMENDMENTS CHANGE?

The 2020 amendments modified the criteria in IAS 1 that must be met in order for a liability to be classified as current or non-current. This classification is important for many entities, as it affects liquidity and gearing ratios, and may affect covenants associated with loans (e.g. minimum working capital ratios).

The amendments included several changes to the requirements of IAS 1. However, the focus by most stakeholders has been on the introduction of a paragraph 72A (**<u>emphasis added</u>**):

> *An entity's right to defer settlement of a liability for at least twelve months after the reporting period must have substance and, as illustrated in paragraphs 73–75, must exist at the end of the reporting period.* ***<u>If the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period</u>****. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date.*

WHAT IS AN EXAMPLE OF AN ENTITY APPLYING IAS 1.72A?

In December 2020, the IFRS Interpretations Committee was asked about how IAS 1.72A should be applied to particular fact patterns. The following fact pattern illustrates the application of IAS 1.72A to one specific case.

Fact Pattern
An entity has a 31 December 20x1 reporting period. The entity has a loan with a repayment term of 31 December 20x6, which is more than one year in the future, however, the loan is subject to covenants. As at 31 December 20x1, the entity must maintain a working capital ratio of at least 1.0, and at 30 June 20x2, the working capital ratio must be 1.1. As at 31 December 20x1, the working capital ratio of the entity was 1.05. Management expects to comply with the covenant test based on 30 June 20x2.

Analysis
The tentative agenda decision issued by the IFRS Interpretations Committee in April 2021 was never finalised. However, in it, the analysis stated that the entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with two specified conditions—a working capital ratio above 1.0 at 31 December 20X1 and a working capital ratio above 1.1 at 30 June 20X2. In applying paragraph 72A of IAS 1, the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period, meaning that the liability would be classified as a current liability as at 31 December 20x1.

WHAT CONCERNS WERE RAISED RELATING TO THE 2020 AMENDMENTS?

The Committee received a significant amount of feedback on the tentative agenda decision. While most did not disagree with the technical analysis of the requirements, many believed that the outcome of applying IAS 1.72A did not provide useful information to users of financial statements.

Classifying the loan as a current liability despite the fact that the entity complied with the covenant in effect as at 31 December 20x1 was counterintuitive to many respondents. Several respondents noted that many covenants have tests and ratios that fluctuate over time, some of which take into account seasonality that is expected by both the borrowers and lenders in setting the covenants.

In response to the concerns raised, the Committee voted to not finalise the tentative agenda decision and instead the matter was referred to the IASB. In June 2021, the IASB tentatively decided to:

- Defer the effective date of the 2020 amendments to no earlier than 1 January 2024; and
- Modify the 2020 amendments.

THE NOVEMBER 2021 EXPOSURE DRAFT

WHAT ARE THE PROPOSALS IN THE EXPOSURE DRAFT?

The exposure draft does not withdraw or replace the 2020 amendments, as several requirements introduced by the 2020 amendments are unaffected by the proposals in the exposure draft.

The exposure draft would amend IAS 1 so that if the right to defer settlement for at least 12 months after the reporting date is subject to an entity complying with conditions after the reporting period, then those conditions would not affect whether the right to defer settlement exists at the end of the reporting period (the reporting date) for the purposes of classifying a liability as current or non-current.

Therefore, if the proposals in the exposure draft were applied to the fact pattern earlier in this document, the analysis would be as follows:

Analysis
As the entity complies with the conditions affecting whether the loan is repayable as at 31 December 20x1 (i.e. the 1.0 working capital ratio test is met), the loan is classified as a non-current liability. The condition in the future (i.e. the 1.1 working capital ratio test as at 30 June 20x2) does affect whether the entity will be able to defer settlement within 12 months from 31 December 20x1. However, it does not affect the classification as at 31 December 20x1.

While the entity would classify the loan as a non-current liability, the exposure draft does propose new presentation and disclosure requirements.

The exposure draft also proposes to clarify that an entity does not have the right to defer settlement of a liability for at least twelve months if the liability could become repayable within twelve months after the reporting period:

(a) At the discretion of the counterparty or a third party (e.g. a loan that is callable by the lender at any time without cause); or

(b) If an uncertain future event or outcome occurs (or does not occur) and its occurrence (or non-occurrence) is unaffected by the entity's future actions (e.g. when the liability is a financial guarantee or insurance contract liability). In such situations, the right to defer settlement is not subject to a condition with which the entity must comply.

WHAT ARE THE PROPOSED PRESENTATION AND DISCLOSURE REQUIREMENTS?

Presentation requirements
An entity would be required to present separately in its statement of financial position 'non-current liabilities subject to conditions in the next 12 months'. This line item would include liabilities classified as non-current for which the right to defer settlement for at least 12 months is subject to the entity complying with conditions after the reporting date.

Therefore, in the example noted above, because the entity's right to defer settlement of its loan for the next 12 months is subject to it complying with a covenant as at 30 June 20x2, it would be required to present the liability separately in the statement of financial position using the caption noted above.

Disclosure requirements
For non-current liabilities subject to conditions, an entity would be required to disclose information about: i. the conditions (for example, the nature of and date by which the entity must comply with the condition); ii. whether the entity would comply with the conditions based on its circumstances at the reporting date; and iii. whether and how the entity expects to comply with the conditions by the date on which they are contractually required to be tested.

Therefore, in the example noted above, the entity would be required to disclose in its 31 December 20x1 financial statements the nature of the conditions that will be tested as at 30 June 20x2, the fact that the entity would not have complied with the 1.1 working capital ratio test as at 31 December 20x1, and whether the entity expects to comply when the 1.1 working capital ratio test as at 30 June 20x2.

WHEN IS THE EFFECTIVE DATE OF THE PROPOSALS IN THE EXPOSURE DRAFT?

The exposure draft proposes that the amendments would be effective for annual reporting periods beginning on or after no earlier than 1 January 2024 with earlier application permitted. Entities would be required to restate comparative information. The other amendments made to IAS 1 by the 2020 amendments would be effective concurrently.

The exposure draft is open for public comment until 21 March 2022.