Issue 198/November 2021

IFRS Developments

Classification of non-current liabilities with covenants – proposed amendments

What you need to know

- The proposals clarify that a liability may be non-current even if it is subject to covenants to be complied with after the reporting period and the entity would not have complied with those covenants at the end of the reporting period.
- If the proposals are finalised, entities will be required to present non-current liabilities that are subject to covenants to be complied with within twelve months after the reporting period, separately in the statement of financial position.
- Additional disclosures will also be required for those liabilities separately presented as subject to covenants to be complied with within twelve months after the reporting period.
- Comments on the ED are due by 21 March 2022.

Highlights

On 19 November 2021, the International Accounting Standards Board (IASB or the Board) issued IFRS Standards Exposure Draft ED/2021/9 *Non-current Liabilities with Covenants, Proposed Amendments to IAS 1* (the ED) which clarifies how to treat liabilities that are subject to covenants to be complied with, at a date subsequent to the reporting period.

Background

In January 2020, the IASB issued amendments to paragraphs 69 to 76 of IAS 1 *Presentation of Financial Statements* (the 2020 amendments) to specify the requirements for classifying liabilities as current or non-current. A key requirement of the 2020 amendments was that entities that have liabilities that are subject to compliance with covenants at a date subsequent to the reporting period do not have the right to defer settlement of the liabilities at the end of the reporting period, if the entity does not comply with those covenants at that date.

Stakeholders were concerned about the impact of this proposal and, as a result, the IFRS Interpretations Committee (the Committee or the IFRS IC) published a tentative agenda decision (the TAD) in December 2020 explaining how to apply the proposal to three fact patterns. The comments received in response to the TAD raised concerns as to the consequences of the 2020 amendments for certain scenarios, e.g., those applicable to entities whose business is highly seasonal. The Committee agreed and reported the same to the Board, and the Board decided to amend the 2020 amendments with the release of this ED.

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The proposals

In the ED, the Board proposes narrow scope amendments to IAS 1 which effectively reverse the 2020 amendments requiring entities to classify as current, liabilities subject to covenants that must only be complied with within the next twelve months after the reporting period, if those covenants are not met at the end of the reporting period. Instead, the proposals would require entities to present separately all non-current liabilities subject to covenants to be complied with only within twelve months after the reporting period. Furthermore, if entities do not comply with such future covenants at the end of the reporting period, additional disclosures will be required. Thus, although not for the purpose of classification or presentation, under the proposed amendments, entities will also have to consider whether future covenants would have been complied with at the end of the reporting period.

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Separarate Presentation

The Board's proposals would require an entity to present separately non-current liabilities for which the entity's right to defer settlement is subject to compliance with covenants within twelve months after the reporting period. The Board justifies this proposal by highlighting that it will (paragraph BC21):

"a) *avoid users of financial statements being misled by a non-current classification without any indication that the liability could become repayable within twelve months;*

b) *alert users of financial statements to seek additional information about such conditions in the notes; and*

c) *be relevant for all entities that present current and non-current liabilities - such presentation reflects that the non-current classification of some liabilities is not absolute (such a liability could become repayable within twelve months).*"

The proposals would impact the presentation of all non-current liabilities with covenants subject to compliance within twelve months, not only those not met at the end of the reporting date. The latter refers to those liabilities that would have been reclassified to current under the 2020 amendments.

Disclosures about covenants

The proposals require entities to disclose the relevant information about the covenants they must comply with in order to have the right to defer settlement for at least twelve months. This disclosure is required to provide the details of the specific covenants that entities must meet in order to defer the right settle the liability. The Board believes that this information will allow users to understand the nature of the covenants and to assess the risk that a liability classified as non-current could become repayable within twelve months. Furthermore, entities will need to disclose whether they would have complied with the covenants at the reporting date and whether and how they expect to comply with the covenants at the time of testing the covenants.

Right to defer settlement

In addition to addressing the specific concerns raised by respondents to the TAD, the Board has proposed to clarify what is meant by a right to defer settlement in paragraph 69(d) of the Standard. To that effect, the Board proposes to add paragraph 72C which provides that an entity does not have the right to defer settlement if:

a) the liability is callable at the discretion of the counterparty without cause within twelve months after the reporting period; 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 that makes the liability repayable.

Regarding (b), the Board explains that the outcome of a future event may be affected by an entity's actions even if it cannot control that outcome. For example, an entity can affect its future revenue generation, although it cannot control it.

Transition and effective date

The proposals will become effective for annual reporting periods beginning on or after 1 January 2024 and will need be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Early adoption is permitted, but will need to be disclosed.

The Board has also proposed to delay the effective date of the 2020 amendments accordingly, such that entities will not be required to change current practice before the proposed amendments come into effect.

Next steps

The ED is available for public comment until 21 March 2022. The Board will consider comments received before deciding on the amendments.

How we see it

We believe the proposals will limit the impact of the 2020 amendments on current practice. However, as a result of the presentation and disclosure requirements in the ED, entities will need to carefully consider the impact of the 2020 amendments and the proposals of the ED on existing and planned loan agreements. In this context, it is important to highlight that the amendments must be applied retrospectively.

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ED None