IFRS® Foundation

Non-current Liabilities with Covenants

Global Preparers Forum

Agenda Paper 2

March 2022

Contents

Purpose of this session

Background

- In November 2021, the International Accounting Standards Board (IASB) published the *Exposure Draft Non-current Liabilities with Covenants*.*
- The proposals address the information a company provides about **non-current liabilities with covenants** that, if breached, make the liability repayable on demand.
- The proposals would:
  - change how a company classifies such liabilities as **current** or **non-current;** and
  - require companies to (i) **present such liabilities separately** in their balance sheet and (ii) **disclose information** that enables investors to assess the risk that the liability could become repayable within 12 months.

Purpose of the session

- Obtain your views on the proposals and whether they would result in companies providing useful information about non-current liabilities with covenants.

* A *snapshot* with an overview of the proposals is also available on our website.

Background

The classification requirements in IAS 1

A company generally classifies liabilities as **current** or **non-current** as follows:

Current	• **Due to be settled within twelve months**; • Expected to be settled in the **normal operating cycle**; • Liabilities held **for trading; or** • There is no **right to defer settlement** for at least 12 months
Non-Current	• **All liabilities** that are not current

Clarified by amendments in 2020

The clarifications in the 2020 amendments

- In January 2020, the IASB amended IAS 1 to clarify how a company assess whether it has a **right to defer settlement for at least 12 months** when the liability is subject to covenants (2020 amendments). The amendments become effective on 1 January 2023.

- According to the 2020 amendments, a company assesses whether it has a **right to defer settlement for at least 12 months** as follows:

If the right to defer settlement is subject to covenants, the company assesses whether it would be in compliance with the covenants **based on its circumstances at the reporting date**

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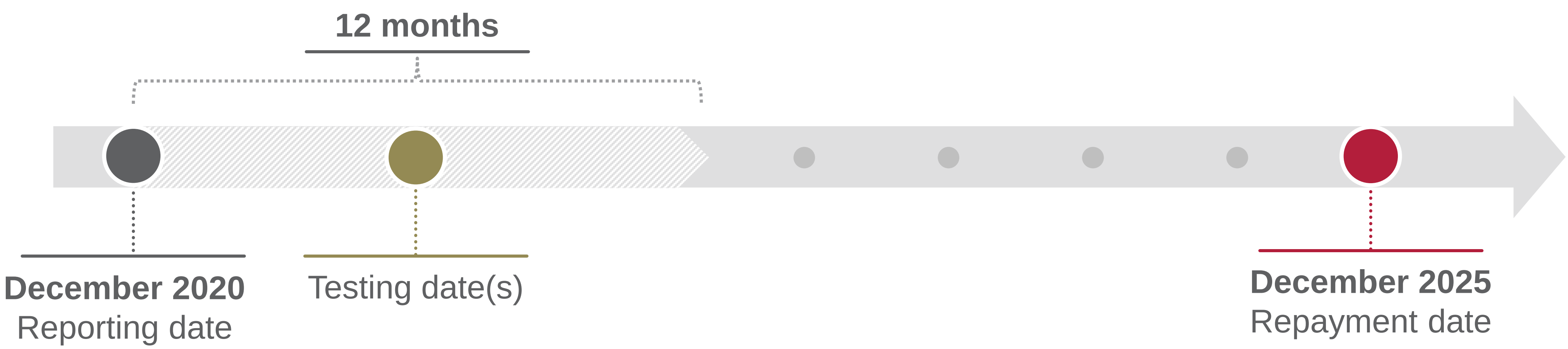
The company has a right to defer settlement only if it would have **complied with the covenants** at the reporting date, even if compliance is required only after that date

The Committee’s discussion

In December 2020, the IFRS Interpretations Committee discussed how the 2020 amendments apply in three different cases. In each of these cases:

- A company has a **loan repayable in five years**
- The loan agreement includes a **covenant** that requires a **minimum working capital ratio** at **specified testing dates**
- The loan becomes **repayable on demand** if this ratio is **not met** at any of the testing dates



Cases and outcomes

		Case 1	Case 2	Case 3
Loan agreement	Repayment date	31/12/2025	31/12/2025	31/12/2025
	Covenant testing dates	Each quarter-end	Each 31 March	Reporting date; then each 30 June
	Required ratio	1.0	1.0	Reporting date: 1.0 Each 30 June: 1.1
Position at 31/12/2020	Actual Ratio:	0.9	0.9	1.0
	Management expects to comply at specified date?	Yes	Yes	Yes
	Additional information:	Company obtained waiver for 3 months	-	-
Classification		Current	Current	Current

The IASB’s considerations

Many **said the outcomes** of applying the 2020 amendments do not provide useful information, particularly in Cases 2 and 3:

What stakeholders said	IASB’s considerations
A company would classify a liability as current even when it has no contractual obligation to repay the liability within 12 months	• A company’s right to defer settlement for 12 months is **not absolute** if it is subject to compliance with covenants—the liability could become repayable if the company fails to comply • The information provided by classification as either current or non-current, alone, is **insufficient to meet investor information needs**—it does not provide information about the potential effects of covenants
The requirements take no account of the design of conditions negotiated to reflect a company’s specific circumstances	• The IASB shared concerns that the 2020 amendments **might not provide useful information** in some situations—for example, when covenants are designed to incorporate the expected effects of: (a) the **seasonality** of a company’s business (b) the company’s **future performance**

The IASB's proposals

The IASB's proposals

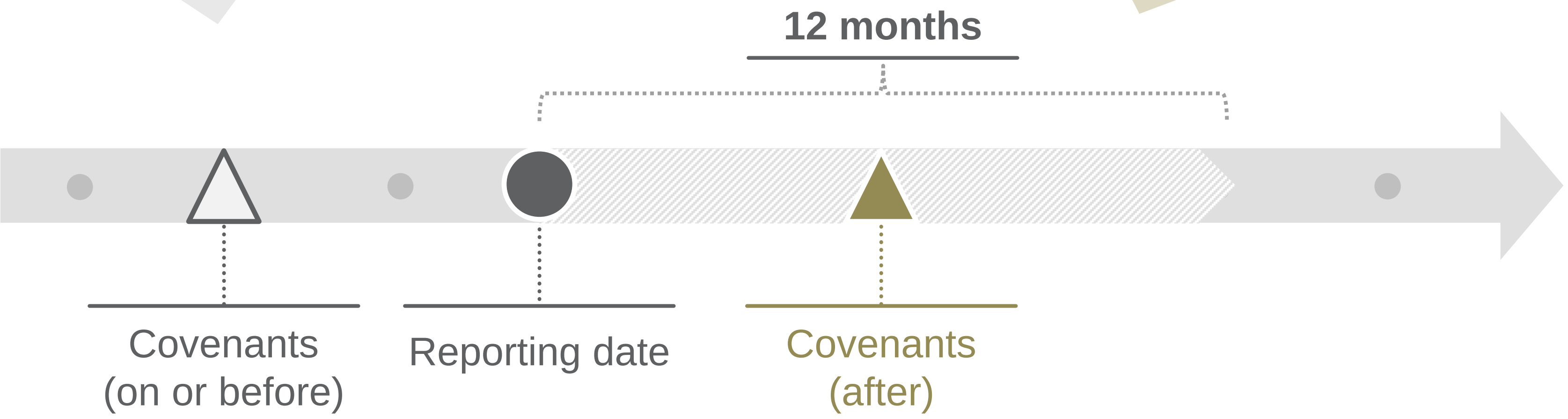
Classification as current or non-current

A company would classify a liability as **current** or **non-current** based on its compliance with covenants required only on or before the reporting date

Presentation and Disclosure

A company would:

- **present separately** non-current liabilities subject to covenants required within 12 months after the reporting date
- **disclose information** to enable investors to assess the risk that the liability could become repayable within twelve months.



Information companies would disclose include:

The **covenants** and whether the company:

- would have complied with them at the reporting date
- expects to comply with them in the future (including how it would do so)

Applying the IASB's proposals

	Compliance with covenants required on or before the reporting date:	Classification	
		2020 amendments	IASB's proposals
Case 1	Breached covenants required on the reporting date. Waiver covers only 3 months.	Current	Current
Case 2	Complied with the covenants required on or before the reporting date.	Current	Non-current*
Case 3		Current	Non-current*

*** Presentation and disclosure:** in cases 2 and 3, the company would present the liabilities in a line item (separate from non-current liabilities without covenants required within 12 months), and disclose information about:

(a) the covenants with which it must comply within 12 months of the reporting date;

(b) the fact that it would not have complied with those covenants based on circumstances at the reporting date; and

(c) whether and how it expects to comply with those covenants by the date they are required.

The IASB's proposals (continued)

Other aspects of the proposals

- Clarify that a company **does not have a right to defer settlement** when the liability could become repayable within 12 months:
  - a) at the discretion of the counterparty or a third party—for example, a loan callable by the lender without cause.
  - b) depending on an uncertain future event or outcome that is unaffected by the company's future actions—for example, a financial guarantee.

Transition and effective date

- Retrospective application in accordance with IAS 8
- **Defer the effective date** of the 2020 amendments to no earlier than 1 January 2024

Questions for GPF members

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1. Do you support the IASB's proposals on:

   a) **classification of liabilities as current or non-current**—only covenants with which the company must comply on or before the reporting date affect classification as current or non-current?

   b) **separate presentation**—companies would present separately on their balance sheet non-current liabilities subject to compliance with covenants within 12 months after the reporting date?

   c) **disclosure of information about covenants—**companies would disclose information that enables investors to assess the risk that the liability could become repayable within twelve months, including:

      i. the covenants (their nature and date on which the company must comply with them)

      ii. whether the company would have complied with the covenants at the reporting date; and

      iii. whether and how the company expects to comply with the covenants in the future?

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