ICAEW
REPRESENTATION 24/22

NON-CURRENT LIABILITIES WITH COVENANTS – PROPOSED AMENDMENTS TO IAS 1

Issued 28 February 2022

ICAEW welcomes the opportunity to comment on ED/2021/9 *Non-current Liabilities with Covenants – proposed amendments to IAS 1* published by the IASB in November 2021, a copy of which is available from this link.

We welcome the Board's attempts to address stakeholder concerns about some of the consequences of the 2020 amendments to IAS 1. We do not, however, support the proposed amendments to the standard's presentation and disclosure requirements. We recommend that the Board looks again at its proposals in these areas and consider whether there may be a more appropriate way forward.

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KEY POINTS

ADDRESSING ISSUES WITH *CLASSIFICATION OF LIABILITIES AS CURRENT OR NON-CURRENT* (‘THE 2020 AMENDMENTS’)

1. We expressed concern in our response to the exposure draft that preceded the 2020 amendments that, in some circumstances, it would have resulted in a company classifying a liability as current even when, at the reporting date, it had no contractual obligation to repay the liability within 12 months.
2. We are pleased that the Board has listened to stakeholder concerns about this outcome and are taking steps to resolve the issues that have been raised.
3. However, we are concerned that the Board has not fully addressed the original issue, that is, to clarify how IAS 1’s classification principles interact with the detailed guidance that follows. The solution that is now being proposed goes far beyond providing the clarification that is needed in this area. We suggest that the Board reconsiders its current proposals and focuses its efforts on ensuring that the original concerns are fully addressed.

CLASSIFICATION

4. We are broadly supportive of proposed guidance on classification of liabilities as current and non-current as it is a helpful codification of what was the prevailing practice before the 2020 amendments were issued and should reduce diversity in practice.
5. Notwithstanding our concerns about other elements of the proposals, it is imperative that the Board issues an amendment updating its guidance specifically dealing with classification of liabilities as current and non-current as soon as possible. The extant version of IAS 1 incorporating the 2020 amendments urgently needs fixing before it comes into effect. On the other hand, our concerns about the proposed disclosure and presentation requirements can be addressed as part of the Board’s longer-term deliberations on the broader issue of how to disclose and present liabilities subject to covenants and other specified conditions.
6. See our response to question 1 below for more details.

DISCLOSURES

7. We are not supportive of the proposed disclosure requirements. We believe that they are too wide ranging and may result in excessively detailed disclosures and unnecessary clutter in the financial statements, particularly for entities with multiple sources of debt finance. A better solution may be to make targeted changes to IFRS 7’s existing liquidity risk disclosures and/or supporting guidance.
8. See our response to question 1 below for more details.

PRESENTATION

9. We do not agree with the proposals to require preparers to present non-current liabilities subject to compliance with specified conditions within twelve months after the reporting period separately in the statement of financial position.
10. See our response to question 2 below for more details.

ANSWERS TO SPECIFIC QUESTIONS

Question 1 – Classification and disclosure (paragraphs 72B and 76ZA(b))

The Board proposes to require that, for the purposes of applying paragraph 69(d) of IAS 1, specified conditions with which an entity must comply within twelve months after the reporting period have no effect on whether an entity has, at the end of the reporting period, a right to defer settlement of a liability for at least twelve months after the reporting period. Such conditions would therefore have no effect on the classification of a liability as current or non-current. Instead, when an entity classifies a liability subject to such conditions as non-current, it would be required to disclose information in the notes that enables users of financial statements to assess the risk that the liability could become repayable within twelve months, including:

- ***(a) the conditions (including, for example, their nature and the date on which the entity must comply with them);***
- ***(b) whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period; and***
- ***(c) whether and how the entity expects to comply with the conditions after the end of the reporting period.***

Paragraphs BC15–BC17 and BC23–BC26 of the Basis for Conclusions explain the Board's rationale for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

11. We were always uncomfortable with the 2020 amendments which, in some circumstances, would have required a company to classify a liability as current even when, at the reporting date, it had no contractual obligation to repay the liability within 12 months.
12. In our view, classifying liabilities as current or non-current based on possible future breaches of debt covenants is at odds with the accruals basis of accounting, which paragraph 1.17 of the Conceptual Framework describes as depicting 'the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur…'.
13. We are therefore broadly supportive of the proposed amendments to paragraph 72A and the additional guidance that is added in paragraphs 72B and 72C, as these amendments will ensure that a company classifies liabilities as current or non-current based on its compliance with covenants required only on or before the reporting date. The proposed amendments are a helpful codification of what was the prevailing practice before the 2020 amendment was issued and should reduce diversity in practice.
14. The drafting of these paragraphs could, however, be improved. For example:
    - It isn't clear whether paragraphs 72B (which refers to covenants) and 72C (which looks at other conditions) are intended to be mutually exclusive. Clarity is needed.
    - Paragraph 72C(b) refers to future events or outcomes that are 'unaffected by the entity's future actions' but this may be difficult to interpret and could lead to more rather than less diversity in practice. For example, there is a risk of differing interpretations when assessing whether or not a change of control is affected by the entity's future actions. The basis for conclusions explains the difference between being able to control future events or outcomes and being able to affect them. In our view, this is in an important clarification that should be included in the body of the amendment rather than in the basis for conclusions.

15. When liabilities are subject to covenants, we agree that it may be helpful – in some circumstances – to provide users of the financial statements with information about the possible risk of future non-compliance and the consequences of such a breach. We are, however, concerned that the proposals as drafted are too wide ranging and may result in excessively detailed disclosures and unnecessary clutter in the financial statements, particularly for entities with multiple sources of debt finance.

16. We are therefore not supportive of the proposed disclosure requirements as drafted in paragraph 76ZA(b) as they would require detailed disclosure for all liabilities with covenants even where there is little or no risk of those covenants being breached. Requiring disclosure only when there is a significant risk of non-compliance would mitigate some of our concerns about excessive disclosure.

17. However, a better solution maybe to make targeted changes to the IFRS 7's existing liquidity risk disclosures and/or supporting guidance. These requirements already require entities to provide an analysis of liabilities based on contractual maturities. Information about the risks and uncertainties relating to possible non-compliance with covenants could be added to this existing information when it is considered material.

Question 2 – Presentation (paragraph 76ZA(a))

The Board proposes to require an entity to present separately, in its statement of financial position, liabilities classified as non-current for which the entity's right to defer settlement for at least twelve months after the reporting period is subject to compliance with specified conditions within twelve months after the reporting period.

Paragraphs BC21–BC22 of the Basis for Conclusions explain the Board's rationale for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, do you agree with either alternative considered by the Board (see paragraph BC22)? Please explain what you suggest instead and why.

18. We do not agree with the proposals to require preparers to present non-current liabilities subject to compliance with specified conditions within twelve months after the reporting period separately in the statement of financial position.

19. Creating a new line item on face of the statement of financial position highlighting such items could potentially be misleading as it may suggest to users that there is cause for additional concern when in fact there is none, because the risks of non-compliance may be negligible. Moreover, doing so will provide users with no useful information about the risks of non-compliance.

20. In common with the alternative view of Mr Mackenzie and Mr Scott, we believe that requiring such presentation requirements is contrary to the principles-based nature of IFRS standards which already include a requirement to present line items separately when such presentation is relevant to an understanding of an entity's financial position.

21. We are concerned that the proposals would result in significant numbers of non-current liabilities being captured by this requirement as many loans will contain covenants that are tested on annual basis. The requirements are therefore likely to be onerous for preparers, with the costs outweighing the benefits.

22. The lack of clarity about what is meant by 'specified conditions' may also lead to diversity in practice unless this term is defined more clearly. It is not clear for example, whether these 'specified conditions' are limited to what are widely regarded as 'covenants'. There are many conditions – including some that are dependent on whether uncertain future events or

outcomes occur or do not occur – which would not generally be referred to as covenants. The treatment of such conditions is unclear. For example, it is unclear whether change of control clauses in loan agreements (ie, clauses permitting the lender to demand early repayment if there is a change of control over the borrower) should be considered when assessing whether separate disclosure is required.

Question 3 – Other aspects of the proposals

The Board proposes to:

- ***(a) clarify circumstances in which an entity does not have a right to defer settlement of a liability for at least twelve months after the reporting period for the purposes of applying paragraph 69(d) of IAS 1 (paragraph 72C);***
- ***(b) require an entity to apply the amendments retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, with earlier application permitted (paragraph 139V); and***
- ***(c) defer the effective date of the amendments to IAS 1, Classification of Liabilities as Current or Non-current, to annual reporting periods beginning on or after a date to be decided after exposure, but no earlier than 1 January 2024 (paragraph 139U).***

Paragraphs BC18–BC20 and BC30–BC32 of the Basis for Conclusions explain the Board's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

23. As noted above, we are broadly supportive of the proposed changes to paragraph 72C. We have, however, highlighted some concerns about the drafting of this paragraph in our response to question 1 above.
24. We are supportive of the proposals to require entities to apply the amendments retrospectively in accordance with IAS 8, with earlier application permitted.
25. We are supportive of the proposals to defer the effective date of the 2020 amendments to no earlier than 1 January 2024 as this would mean that companies would not be required to change their assessment of the classification of liabilities before the proposed amendments are in effect.