Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Non-current Liabilities with Covenants**	**Meeting**	AASB February 2021 (M185)
Topic:	**Summary of Stakeholder Feedback**	**Agenda Item:**	7.3
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Summary of Stakeholder Feedback

1 This paper summarises the feedback from outreach activities on the matters raised on AASB ED 316 (ED 316) *Non-current Liabilities with covenants* (IASB ED/2021/9). These include discussions with the:

- 16 December 2021 – AASB's Disclosure Initiative Project Advisory Panel (DI PAP). Six DI PAP members provided feedback to AASB staff;
- 13 January 2022 – meeting with one representative from the Australian Institute of Company Directors (AICD);
- 25 January 2022 – meeting with representatives from two professional bodies;
- 3 February 2022 – AASB staff attended a joint meeting arranged by CAANZ and CPA Australia to obtain the views of their members. Six members, including four auditors and two preparers, provided feedback on ED 316; and
- other targeted consultations. One individual stakeholder [preparer] provided feedback to AASB staff.

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[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);

1 Paragraph 69(d) of AASB 101 *Presentation of Financial Statements* requires that an entity shall classify a liability as current when it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

(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.
Proposals in the ED: Para 76ZA: When an entity classifies liabilities subject to the conditions described in paragraph 72B(b) as non-current, the entity shall: (a) present such liabilities separately in its statement of financial position. The entity shall use a description that indicates that the non-current classification is subject to compliance with conditions within twelve months after the reporting period. (b) 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: (i) the conditions with which the entity is required to comply (including, for example, their nature and the date on which the entity must comply with them); (ii) whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period; and whether and how the entity expects to comply with the conditions after the end of the reporting period.
Feedback to Q1
All of the stakeholders participating in the outreach supported the proposal that compliance with debt covenants within twelve months after the reporting date should not affect the classification of a liability as current or non-current at the reporting date. Stakeholders considered that the proposals in ED 316 address the issues with the IAS 1 amendments *Classification of Liabilities as Current or Non-current* (AASB 20201) and would encourage more consistent application in comparison to the 2020 amendments. Stakeholders generally agreed with proposals for disclosure requirements, with the following concerns raised: • Two stakeholders [preparers] commented that it could be challenging to implement the proposed requirements in paragraph 76ZA(b)(a) in practice. Individual debts may have various covenants. In the case an entity has many debts, it is unclear how the disclosures could be aggregated to avoid voluminous disclosures. It is not practical for such an entity to spell out every covenant in the notes to the financial statements. One stakeholder suggested IASB considers developing further guidance (e.g. grouping mechanism) to help entities with the disclosure. Another stakeholder [regulator] agreed that further guidance would be helpful and noted that materiality would determine the disclosure decision. • Four stakeholders [auditors and a preparer] raised concerns about the limited usefulness of information required by paragraph 76ZA(b)(iii)) to general purpose financial statement (GPFS) users and practical challenges in providing this information. To meet this requirement, the entities would need to provide forward-looking information, which may involve a high level of judgement. The subjectivity of the forecasts might compromise its usefulness to GPFS users. Also, entities could be hesitant to disclose details due to confidentiality issues. Stakeholders were also concerned that the complex judgements involved in the forward-looking information would create challenges for auditors. For example, some arrangements may include a change in key management personnel clause, which can require entities to estimate

the probability of KMP's retention when assessing its compliance with covenants. Such information would be confidential and can be difficult to audit due to its subjectivity.

- One stakeholder [auditor] also commented that proposed disclosure requirement in 76ZA(b)(iii) appears to be, in part, the logical extension of paragraphs 76ZA(b)(i) and paragraphs 76ZA(b)(ii), respectively). However, it may not add any value to the information provided. Entities may provide boilerplate disclosures that are difficult to audit. This stakeholder noted that similar disclosures are currently required by paragraph 39(c) of IFRS 7 *Financial Instruments: Disclosures.*[2] However, this stakeholder is of the view that entities rarely address this requirement unless there is a going concern issue and they have to disclose the underlying assumptions and judgements for the going concern conclusion, some of which relate to the risks around liquidity. This stakeholder suggested that the IASB considers incorporating the disclosures within the liquidity risk disclosures in IFRS 7. Two stakeholders [auditors] also commented that the proposed disclosure 76ZA(b)(ii) and (iii) overlay with the going concern and IFRS 7 disclosure requirements. Therefore, the usefulness of proposed disclosure requirement in ED 316 may be limited and may lead to boilerplate disclosures.
- Another stakeholder [preparer] also considered the proposed disclosure in paragraphs 76ZA(b)(ii) and (iii). Entities would be reluctant to disclose that they expect to breach covenants at a future date, as it could negatively affect the market. The entities usually provide financial information, including those related to covenants in the guidance to the market, enabling users to understand the entity's financial position.
- One stakeholder[preparer] commented that investors would get comfort in understanding how much headroom entities have in calculating forward-looking information and suggested the IASB consider developing disclosure requirements accordingly.
- Two stakeholders [professional bodies] considered that the proposal addresses many stakeholders' concerns about the 2020 amendments and the IFRIC tentative decision.[3] However, the stakeholder was concerned that, in practice, the entities could still face challenges with the classification of the debt as current or non-current. Determining whether an entity has the right to defer a liability for at least twelve months is subjective and requires complex judgement. The stakeholder commented there is a need for clear guidance (and educational material) to assist entities in making the classification decision. For example, this stakeholder considered the term "substance" in paragraph 72A[4] to be ambiguous and requires further clarification.

  This stakeholder commented that the proposed disclosure in paragraph 76ZA(b)(iii) would require entities to provide forward-looking information, which may impose an undue burden for entities if required information is not readily available.

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2 Paragraph 39(c) of IFRS 7 requires an entity to disclose a description of how it manages the liquidity risk inherent in paragraph 39(a) – a maturity analysis of non-derivative financial liabilities, and paragraph 39(b) – a maturity analysis for derivative financial liabilities.

3 The IFRS Interpretations Committee (IFRS IC) further concluded that, applying the 2020 amendments, an entity could not classify a liability as non-current when it did not comply with covenants based on its circumstances at the reporting date, even though compliance was required only within twelve months after the reporting period. Stakeholders raised concerns about the tentative agenda decision and noted that the requirements do not consider specific conditions negotiated to reflect an entity's circumstances, such as the seasonality of the business or the entity's future performance.

4 Paragraph 72A states that "an entity's right to defer settlement of a liability for at least twelve months after the reporting must have substance and, as illustrated in paragraphs 72B-75, must exist at the end of the reporting period.

- One stakeholder [preparer] commented that the cost to prepare the proposed disclosures could be onerous, particularly for the multinational enterprises who may need to balance between disclosing forward-looking information and managing litigation risk (e.g. in certain jurisdictions, disclosing forward-looking information could lead to litigation); and for entities with many subsidiaries who may spend a lot of effort to consolidate the required disclosures.

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

The IASB 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.

Feedback to Q2

Stakeholders had mixed views on the proposal suggesting the separate presentation of non-current liabilities that are subject to compliance with conditions within twelve months after the reporting period. Stakeholders raised the following concerns:

- Three stakeholders [preparers and auditor] agreed with the proposal. One stakeholder [preparer] indicated that the cost to implement the proposed requirement is not likely to be onerous as the required information is usually readily available. Two stakeholders from the public sector did not have any concerns about the proposal as public sector entities' debts are rarely subject to any covenants.
- Four stakeholders [auditor, preparer and professional bodies] disagreed with the proposals and commented that the separate presentation requirement appears too prescriptive, which does not necessarily align with the principle-based accounting standards that IASB has pursued in other recent projects (e.g. Primary Financial Statement project). These stakeholders considered it unnecessary to require the separate presentation of debts with covenants on the face of the financial statements as AASB 101 already requires further disaggregation in the statement of financial position when it is relevant to an understanding of an entity's financial position.
- Four stakeholders [auditors and a preparer] prefer to disclose the information on liabilities with covenants in the notes to financial statements rather than on the face of the financial statements.
- Another stakeholder [auditor] who disagreed with the proposals commented that accounting standards should not create a rule where one type of contingency is highlighted in the statement of financial position while ignoring others. Contingency is a feature of all balance sheet items, for example, the amount and timing of a receivable might be contingent on the debtor refinancing its arrangements, classification of an item of PPE might be contingent on mechanic's findings during the next overhaul, or the carrying amount and classification of E&E assets are contingent on the explorer finding economically viable deposits. Many of these contingencies are possibly as significant to the future performance of the entity as contingencies related to debt covenants. If the IASB considers it necessary to classify debt with covenants separately, it should also consider developing similar requirements for other items with similar levels of importance and contingency.

This stakeholder acknowledges the IASB comments around the challenges of reflecting conditionality in a binary classification (e.g. determining whether an entity has the right to defer settlement can be highly subjective and requires complex judgement) as outlined in paragraphs BC9-BC11 of ED 316. However, practitioners should be able to effectively deal with this issue by applying recognition, measurement and classification requirements (similar to the application of judgement in other areas, for instance, uncertainty over income tax treatments).

This stakeholder suggested that the matter should be addressed as part of the Primary Financial Statements project rather than as part of the amendment relating to clarification of classification of debt with covenants.

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)[5] 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.

ED316 proposed the following amendments to AASB 101:

72C An entity does not have the right to defer settlement of a liability for at least twelve months (as described in paragraph 69(d)) if the liability could become repayable within twelve months after the reporting period:

(a) at the discretion of the counterparty or a third party—for example, when a loan 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—for example, 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 as described in paragraph 72B.

Transition and effective date ...

139U Classification *of Liabilities as Current or Non-current*, issued in January 2020 amended paragraphs 69, 73, 74 and 76 and added paragraphs 72A, 75A, 76A and 76B. An entity shall apply those amendments for annual reporting periods beginning on or after [date to be decided after exposure, but no earlier than 1 January 2024] ~~1 January 2023~~ retrospectively in accordance with IAS 8. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

5 See footnote 1 on page 1.

139V *Non-current Liabilities with Covenants*, issued in [Month, Year], amended paragraphs 71 and 72A and added paragraphs 72B–72C and 76ZA. An entity shall apply those amendments for annual reporting periods beginning on or after [date to be decided after exposure, but no earlier than 1 January 2024] retrospectively in accordance with IAS 8. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Feedback to Q3

Stakeholders generally supported the proposal to clarify circumstances relating to deferring liability settlement, and two stakeholders were unsure.

- Two stakeholders [professional bodies] commented that the proposed requirements in paragraph 72C are too ambiguous. It may be difficult for preparers to determine whether the entities have the right to defer the settlement for at least twelve months. The stakeholders are concerned that these new requirements could lead to classifying many loans as current. The stakeholders are of the view that such situation does not necessarily reflect the economic substance of the conditions imposed by lenders, the rights granted to the borrower under such loan agreements, or lender's expectations in respect of such loans.
- Five stakeholders [auditors] commented that the proposed requirements in paragraph 72C(b) is unclear and could be difficult to apply in practice. For example, some covenants may include market capitalisation clauses. Compliance with the covenants requires the entities market capitalisation to be above a certain level. It can be challenging to determine the extent to which entities' future actions would affect their market capitalisation and further determine whether paragraph 72C(b) would apply. Additional clarification would be helpful.

Stakeholders expressed mixed views about the proposal's retrospective application to the amendments. Two stakeholders [auditor and regulator] were concerned that the cost to apply the amendments retrospectively would likely outweigh their benefit. Two stakeholders [preparers] commented the key challenge for retrospective application is that decisions made about the classification of liabilities for the comparative periods may not faithfully reflect how the liability would have been classified in the prior period, as the judgement could have been applied differently. As such, the benefit of a retrospective application is limited.

All stakeholders who participated in the outreach agreed with the proposal to defer the effective date of the amendments to IAS 1 (AASB 101).