Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Non-current Liabilities with Covenants**	**Meeting:**	December 2022 (M192)
Topic:	**Ballot Draft AASB 2022-Z *Amendments to Australian Accounting Standards – Non-current Liabilities with Covenants* for Board Voting**	**Agenda Item:**	6.1
		Date:	28 November 2022
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Objective of this paper

1 The objective of this paper is to provide the Board with:

(a) an update on the IASB's Non-current Liabilities with Covenants project; and

(b) a ballot draft version of amending Standard AASB 2022-Z *Amendments to Australian Accounting Standards – Non-current Liabilities with Covenants* for voting.

Attachments

Agenda paper 6.2	Ballot Draft: AASB 2022-Z *Amendments to Australian Accounting Standards – Non-current Liabilities with Covenants*
Agenda paper 6.3	AASB Comment Letter on IASB ED/2021/9 *Non-current Liabilities with Covenants* [supporting material folder]
Agenda paper 6.4	IFRS Accounting Standard Amendments to IAS 1 *Non-current Liabilities with Covenants* [supporting material folder]

Structure

2 This paper is structured as follows:

(a) Background (paragraphs 3 – 11)

(b) Project update (paragraphs 12 – 15)

(c) Due progress requirements (paragraphs 16 – 18)

(d) Staff recommendation (paragraphs 19 – 25)

Background

3 [AASB 101 *Presentation of Financial Statements*], which incorporates IAS 1 *Presentation of Financial Statements*, requires an entity to classify a liability as non-current only if the entity has the right to defer settlement of the liability for a period of at least twelve months after the reporting date (right to defer settlement). Without this right, the entity might be unable to avoid repaying the liability within twelve months of its reporting date.

4 In January 2020, the IASB issued amendments to the IAS 1 *Classification of Liabilities as Current or Non-current*. The amendments were issued in Australia as AASB 2020-1 *Amendments to Australian Accounting Standards – Classification of Liabilities as Current or Non-current*. These amendments clarified how an entity assesses whether it has the right to defer settlement of a liability when that right is subject to compliance with specified conditions (often referred to as 'covenants') within twelve months after the reporting date.

5 The IFRS Interpretations Committee (IFRS IC) received feedback that different interpretations of the amendments may result in inconsistent application. Following this feedback, the IFRS IC discussed how an entity, applying paragraph 69(d) of IAS 1,[1] determines whether it has the right to defer settlement of a liability for at least twelve months after the reporting period when (a) the right to defer settlement is subject to the entity complying with specified conditions; and (b) compliance with the specified conditions is tested at a date after the end of the reporting period. The IFRS IC concluded that by 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. The IFRS IC decided not to add a standard-setting project to the IASB workplan and published a tentative agenda decision reflecting its discussions.

6 Stakeholders raised concerns about the IFRS IC tentative agenda decision. They 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. Stakeholders were also concerned that the requirements could result in an entity classifying a liability as current even if, at the end of the reporting period even, the entity has no contractual obligation to settle the liability at that date or within 12 months. Stakeholders were also unclear about how an entity would assess at the reporting date whether it would have complied with covenants that are not based on an entity's financial position or performance (non-financial covenants) and covenants based on cumulative financial performance or cash flows for a period extending beyond the reporting period (financial performance covenants).

7 To address stakeholders' concerns, the IASB issued ED/2021/9 *Non-current Liabilities with Covenants* in November 2021 to propose specifying that conditions an entity must comply with within twelve months after the reporting date do not affect the classification of a liability as current or non-current at the reporting date. Instead, the proposals would require an entity to:

(a) present non-current liabilities, which are subject to compliance with specific conditions separately in its balance sheet [proposed paragraph 76ZA(a)];

(b) disclose:

(i) information in the notes about the conditions it must comply with (e.g. nature and date) [proposed paragraph 76ZA(b)(i)];

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1 "An entity shall classify a liability as current when: …
(d) 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.
An entity shall classify all other liabilities as non-current." IAS 1 paragraph 69(d) (2020 Amendments).

(ii) whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period [proposed paragraph 76ZA(b)(ii)]; and

(iii) whether and how the entity expects to comply with the conditions after the end of the reporting period [proposed paragraph 76ZA(b)(iii)].

8 ED/2021/9 also proposed clarifying that an entity does not have a right to defer settlement and thus would classify a liability as current – when the liability could become repayable within twelve months:

(a) at the discretion of the counterparty or a third party – for example, when the lender can call a loan at any time without cause [proposed paragraph 72C(a)]; or

(b) if an uncertain future event or outcome occurs and its occurrence is unaffected by the entity's future actions – for example, when the liability is a financial guarantee or insurance contract [proposed paragraph 72C(b)].

9 Lastly, ED/2021/9 also proposed deferring the effective date of the 2020 amendments to apply no earlier than 1 January 2024. Entities would, therefore, only be required to change their assessment of the classification of liabilities after the proposed amendments were in effect.

10 In December 2021, the Board issued an equivalent Exposure Draft ED 316 *Non-current Liabilities with Covenants* to gauge Australian stakeholders' feedback on the proposals. Staff received feedback on the proposals in the Exposure Draft via:

(a) consultation with the AASB User Advisory Committee, comprising a range of primary users of financial statements;

(b) consultation with the AASB's Disclosure Initiative Project Advisory Panel, which comprises subject matter experts across a range of stakeholder groups; and

(c) other targeted consultations with financial statement preparers, auditors, professional bodies and regulators.

11 Based on the feedback received from Australian stakeholders, the Board's submission to the IASB on ED/2021/9 in March 2022 raised the following key points:

(a) the Board agreed that the proposed changes in ED/2021/9 would provide useful information to users. However, recognising the potential implementation challenges, the Board recommended that the IASB:

(i) consider the interaction between the proposals in ED/2021/9 and the IASB's Primary Financial Statements project, the Management Commentary project and IFRS 7 *Financial Instruments: Disclosures* to ensure consistent principles are applied and to avoid duplicative requirements;

(ii) develop additional guidance concerning aggregation criteria to help entities with the identification of similar economic characteristics for specified conditions when disclosing the conditions required by proposed paragraph 76ZA(b)(i) (see paragraph 7(b));

(iii) require entities to disclose whether and how an entity expects to comply with the conditions after the end of the reporting period (i.e. proposed paragraph 76ZA(b)(iii) – see paragraph 7(b)(iii)) only if the entity would not have complied with the specified conditions based on its circumstances at the end of the reporting period;

(iv) consider whether the proposed disclosure requirement regarding whether and how an entity expects to comply with the conditions after the end of the reporting period should be subject to an "undue cost" proviso;

(v) clarify the requirement regarding uncertain future events (proposed paragraph 72C(b) – see paragraph 8(b)) and develop application guidance; and

(vi) consider the potential unintended legal consequence in some jurisdictions of issuing the amendment to the Standard without specifying a particular date.

(b) the Board disagreed with the proposals in ED/2021/9 to:

(i) require an entity to present separately, in its statement of financial position, non-current liabilities that are subject to compliance with specified conditions within twelve months after the reporting period (proposed paragraph 76ZA(a) – see paragraph 7(a)). The Board suggested that note disclosure would be sufficient; and

(ii) apply the amendments retrospectively. Instead, the Board suggested that prospective application would be more appropriate.

Project update

12 After considering stakeholder feedback on ED/2021/9, in October 2022, the IASB finalised its proposals and issued *Non-current Liabilities with Covenants* (Amendments to IAS 1).[2]

Amendments to IAS 1 (AASB 101)

13 In responding to concerns about the proposals in ED/2021/9, the IASB finalised the amendments and decided not to proceed with the following aspects of the ED/2021/9 proposals:

(a) *Separate presentation of non-current liabilities with covenants* (see paragraph 7(a)) – the main reason for this proposal was to avoid users of financial statements being misled by a non-current classification without any indication that the liability could be repaid within 12 months.[3]

As feedback suggested that users of financial statements would not be misled if the conditionality of non-current liabilities were explained in the notes instead of through separate presentation of these liabilities in the statement of financial position, the IASB decided not to finalise this proposal. Instead, in providing information about non-current liabilities with covenants in the notes, an entity is required to disclose the carrying amount of related liabilities.

(b) *Disclosure about expected compliance with covenants* (see paragraph 7(b)(ii) – 7(b)(iii)) – ED/2021/9 proposed to require an entity to disclose whether and, if so, how an entity is expected to comply with covenants after the reporting date.[4]

In response to stakeholders' concerns that the costs of providing this information might outweigh its benefits, the IASB decided to require an entity to disclose any facts and circumstances that indicate the entity may have difficulty complying with covenants. The IASB concluded that this information would not be overly costly to preparers and would be useful to users of financial statements by helping them to understand the risk that non-current liabilities with covenants could become repayable within twelve months.

(c) *Other conditional settlement terms* (see paragraph 8) – the proposed amendments were intended to clarify some situations in which an entity would not have an unconditional right to defer settlement of a liability.

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2 IFRS – Non-current Liabilities with Covenants

3 The Board did not support this proposal - see paragraph 11(b)(i).

4 The Board supported disclosures about whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period. However, the Board did not support disclosing whether and how the entity expects to comply with the conditions after the end of the reporting period. See paragraphs 11(a)(i) – 11(a)(iv).

Feedback suggested that the proposed clarification would fail to achieve that objective.[5] Therefore, the IASB decided to specify that the requirements in paragraph 72B apply only to liabilities arising from loan arrangements and not include in the final amendments the proposed clarification for situations in which an entity would not have a right to defer settlement of a liability.[6]

14 The IASB's final amendments broadly addressed the Board's concerns about the ED/2021/9 proposals. However, the Board also suggested:

(a) developing additional guidance to support entities in disclosing the required information about the conditions an entity has to comply with.

Instead of information in the notes about the conditions an entity must comply with (e.g. nature and date) (see paragraph 7(b)(i)), the IASB decided to require an entity to disclose information about the covenants (including the nature of the covenants and when the entity is required to comply with them) and the carrying amount of related liabilities in the notes. The IASB concluded that this information would be useful to users of financial statements by helping them to understand the risk that non-current liabilities with covenants could become repayable within twelve months.

The IASB decided not to provide additional guidance because it considered that entities in need of further guidance when making materiality judgements for required information about the covenants could refer to paragraphs 30A and 31 of IAS 1[7] or paragraphs 81–83 of IFRS Practice Statement 2 *Making Materiality Judgements*[8] for guidance on assessing the materiality of information about covenants.[9]

(b) instead of retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, prospective application would be preferable.

The IASB decided to retain the retrospective application of the amendments in accordance with IAS 8. Earlier application is also permitted, but only if the 2020 amendments are also applied on the same date. The IASB is of the view that classifying a liability as current or non-current on the same basis in current and prior periods results in more comparable and, thus, more useful information than the information

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5 The Board did not support classifying a liability as current if an uncertain future event or outcome occurs and its occurrence is unaffected by the entity's future actions. See paragraph 11(a)(v).

6 Staff have heard positive feedback from Australian stakeholders on the final IASB amendments, including an intention to early adopt them. Staff understand that Australian stakeholders were concerned about proposed paragraph 72C in ED/2021/9 because commercial banking arrangements in Australia often include a material adverse change or similar clause (i.e. the right to defer settlement of the liability for at least twelve months is subject to the occurrence (or non-occurrence) of uncertain future events outcomes). Staff understand that applying the 2020 Amendments and the IFRS IC tentative agenda decision, some Australian stakeholders were concerned that liabilities subject to material adverse change clauses might have been reclassified from non-current to current liabilities, which was a significant change to common practice in Australia.

7 In applying the requirements in paragraphs 30A and 31 of IAS 1, an entity would assess what information about covenants is material and determine how to aggregate such information. Accordingly, the entity would not disclose immaterial information about covenants that would reduce the understandability of its financial statements by obscuring material information.

8 That guidance explains that:
(i) an entity considers both the consequences and the likelihood of a breach occurring when assessing whether information about a covenant is material; and
(ii) information about a covenant for which there is only a remote likelihood of a breach occurring is immaterial irrespective of the consequences of that breach.

9 Paragraph BC48EE of the *Non-current Liabilities with Covenants* (Amendments to IAS 1).

that would result from not reclassifying comparative amounts. The IASB also did not expect applying the amendments retrospectively to be onerous for entities.[10]

Other amendments

15 In finalising the amendments in *Non-current Liabilities with Covenants* (Amendments to IAS 1), the IASB also amended IFRS Practice Statement 2 *Making Materiality Judgements*. The amendment illustrates the disclosure requirement in paragraph 76ZA of IAS 1 to disclose, in specified circumstances, information in the notes that enables users of financial statements to understand the risk that non-current liabilities with covenants could become repayable within twelve months after the reporting period.

Due process requirements

16 As per the *AASB For-Profit Entity Standard-Setting Framework*, "In accordance with the Financial Reporting Council's broad strategic directions to the AASB, the AASB sets Standards that:

(a) enable 'publicly accountable' private sector entities to maintain IFRS compliance; and

(b) for other entities, use IFRS Standards (where they exist) and the principle of transaction neutrality (modified as necessary), or develop Australian-specific Standards and guidance …".[11]

17 Additionally, per the *AASB For-Profit Entity Standard-Setting Framework*, "differences between Accounting Standards issued in Australia and New Zealand for for-profit entities should be minimised wherever possible to reduce the costs for entities operating trans-Tasman."[12]

18 Staff note that, "Only in rare and exceptional circumstances will additions to IFRS Standards be justified. The AASB disagreeing with the IASB's treatment is unlikely to provide a good reason for changing the requirement in an IFRS Standard."[13]

Staff recommendation

19 Staff recommend that Board members vote to make AASB 2022-Z *Amendments to Australian Accounting Standards – Non-current Liabilities with Covenants* (including any revisions agreed by the members).

20 If Board members vote to make the proposed amending Standard, the content of the Standard will be finalised by replacing "AASB 2022-Z" with the next Standard number in the sequence and the various dates formally inserted into the Standard as indicated. The Standard would then be registered on the Federal Register of Legislation and published on the AASB website.

21 Although the Board did not support some of the proposals which are included in the final IASB amendments (e.g. the retrospective application of the amendments), staff do not consider the amendments to AASB 101 to be significant enough to warrant:

(a) a departure from the IFRS Standards; or

(b) compromising trans-Tasman convergence for for-profit entities.[14]

10 Paragraph BC105FD of the *Non-current Liabilities with Covenants* (Amendments to IAS 1).

11 *AASB For-Profit Entity Standard-Setting Framework* paragraph 3.

12 *AASB For-Profit Entity Standard-Setting Framework* paragraph 27.

13 *AASB For-Profit Entity Standard-Setting Framework* paragraph 37.

14 The NZASB will consider the IASB's amendments at the meeting being held on 13 December 2022.

22 Regarding not-for-profit (NFP) entities, as per the *AASB Not-for-Profit Entity Standard-Setting Framework*, staff do not consider that there are any justifiable circumstances warranting NFP-specific Standards or guidance.

Possible amendments to AASB 1060

23 Subject to Board members agreeing with the staff recommendation in paragraph 19, it will also be necessary for the Board to consider whether similar amendments to *AASB 1060 General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities* are required concerning the classification of liabilities as current or non-current by Tier 2 entities.[15]

24 The *AASB For-Profit Entity Standard-Setting Framework* and *AASB Not-For-Profit Entity Standard-Setting Framework* outline the Board's approach when considering amendments to AASB 1060 following amendments made by the IASB to full IFRS Standards.

25 In light of the positive feedback from Australian stakeholders and their intention to early adopt the amendments to AASB 101, staff will consider the effect of the amendments on AASB 1060 as part of a separate project to be discussed with the Board in early 2023.

Questions to Board members

Q1: Do Board members have any questions or comments?

Q2: Do Board members vote in favour of making AASB 2022-Z *Amendments to Australian Accounting Standards – Non-current Liabilities with Covenants*?

15 Paragraph BC96 of AASB 1060 states that "a review of the disclosures will need to take place any time … amendments are made to existing Australian Accounting Standards or Interpretations".