ED/ Ind AS 1/2022/2

Exposure Draft

Classification of Liabilities as Current or Non-current and Non-current Liabilities with Covenants

Amendments to Ind AS 1

(Last date for Comments: January 30, 2023)

Issued by

Accounting Standards Board

The Institute of Chartered Accountants of India

Question for respondents:
Do you agree with removal of the carve-out made in paragraph 74 of Ind AS 1? If not, why?

Paragraph:74

When an entity ~~Where there is a~~ breach~~es of~~ a ~~material~~ covenant ~~provision~~ of a long term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand ~~on the reporting date,~~ it classifies the ~~entity does not classify the~~ liability as current, even if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have the right to defer its settlement for at least twelve months after that date.

Comments:

SIRC of ICAI agree with the removal of the carve-out made in Paragraph:74 with the following observations:

1. Basically, the Para substitutes the word 'covenant' in the place of the words 'material provision'**.** Since IAS-1 has replaced the word 'condition' by the word 'covenant', Ind As 1 follows suit.

2. Further even there is a breach tolerated by the Lender, Ind As1 don't permit to classify the liability as 'Long-term'.

3. An 'agreement' is between two parties and it is the right of the parties not to enforce the conditions where mutually agreed. Accounting standard cannot say, 'it won't recognize the modification of the agreement which is legal'! Accounting cannot go beyond legality.

4. A 'covenant' is a promise by one party to do something for the other party. A 'condition' is an event or occurrence that will trigger one or more obligations under the contract. Until that event or occurrence takes place, there is no obligation to perform under the contract.

5. A loan's classification is assessed based on a 'snapshot' of conditions existing at the reporting date. As a result, classification is not affected by the existence or expected outcome of future covenant tests. It follows that the insertion of an additional covenant test within the next 12-months period as part of the waiver does not ordinarily prevent classification of the loan as non-current at the reporting date.

6. The effect of this provision is that companies whose accounts are prepared in accordance with Ind AS 1 must classify liabilities in their accounts as “current” if, as at the reporting date, they do not have the right to defer payment for twelve months or more. This would often be the case under most loan documentation if a covenant breach is discovered after the Ind AS 1: implications for companies facing a potential financial covenant breach testing date and pending the relevant creditors’ agreement to waive the breach. Crucially, even if the company is able to obtain a waiver of a covenant breach from its creditors after the reporting/testing date and before the issuance of the relevant financial statements, Ind AS 1 would still require the liability to be classed as “current”. Disclosing a group’s corporate loan facility as a current liability rather than a non-current liability could have significant adverse consequences. For instance, commercial counter-parties may infer that the company is facing a liquidity issue. While a company should typically be able to disclose a subsequent waiver as a material non-adjusting event in the notes to its balance sheet, ideally, borrowers will wish to address the issue before the reporting date. This issue is often managed in practice by agreeing and documenting a short-term covenant deferral. Broadly, this involves deleting the original financial covenant test and test date in the loan agreement with an alternative test at a new deferred test date. Say, for instance, a loan agreement provided for a covenant to be tested over a 12-month period ending on 30 June and before that date, the company considers that a covenant breach is likely to occur at the 30 June test date. If, at that point, the original covenant was deleted and replaced with a covenant to be tested over a 15-month basis on 30 September, the liability would not need to be classified as current in the 30 June accounts as the reporting period would be still open. Companies could, of course also look to agree a covenant reset or waiver, although this may not be an option where there is limited time for a negotiation ahead of the test date or if a broader restructuring is required.

7. The breach of a loan covenant may indicate the existence of wider problems with a borrower’s overall financial health. While all breaches may cause concern, when a breach remains un-remedied and the lender has obtained a right to demand accelerated repayment of the related loan, this may impact a borrower’s ability to continue as a going concern.

8. A borrower considers the impact of covenant breaches and other relevant factors and assesses whether there are material uncertainties over its ability to continue as a going concern. Even though a breach may not occur until after the reporting date, it must still be considered. If material uncertainties are found to exist, they must be disclosed.

9. Occasionally, the impact of a covenant breach is so severe that the going concern assumption is no longer appropriate and management has little choice but to liquidate or cease operations. When this happens, a company is required to prepare its financial statements on a basis other than going concern. Selecting an appropriate basis will

require the exercise of professional judgment and the basis selected will need to be disclosed.

10. Thus, the above substitution of words, addresses an accounting rather than a legal issue. This additional downside of a potential covenant breach, which in some circumstances, could accelerate a deterioration in the group's financial condition provides further impetus for companies in financial distress to monitor their covenants closely, look ahead to future testing dates and, where appropriate, seek to obtain a waiver or deferral from lenders as early as possible.

11. The rational for removal carve-out by the ASB is that for 6 years of Ind AS implementation have already elapsed, hence, it is appropriate to remove this carve-out. The objective to achieve convergence with IFRS Accounting Standards over a period of time to be achieved after considering the economic status of the country and not by time period elapsed. The ED nowhere explains how the country is ready for this convergence!