

UNIQUS's response to the Institute of Chartered Accountants of India's (ICAI) Exposure Draft (ED) on Classification of Liabilities as Current or Non-current and Non-current Liabilities with Covenants - Amendments to Ind AS 1, Presentation of Financial Statements

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Introduction

The Exposure Draft ("ED") of the Amendments to Ind AS 1, Presentation of Financial Statements, issued by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India on 30 December 2022 proposes amendments relating to the classification of liabilities as current or non-current for breach and subsequent cure of financial and non-financial covenants and aims to eliminate the carve-out provided by Ind AS 1 to align with the classification of liabilities as current or non-current with the principles as set out under IAS 1, Presentation of Financial Statements. It also provides clarification on classifying certain convertible debt as part of the financial statements.

Changes proposed by the ED:

The changes listed in the ED, propose amendments relating to the classification of liabilities as current or non-current which will eliminate the difference between Ind AS 1 and IAS 1 and will also resolve the contradictions between paragraph 69(d) of Ind AS 1, which specifies that the entity should have an unconditional right to defer settlement of liability at least 12 months after the reporting date and paragraph 73 of Ind AS 1 which provides that the entity should have an expectation of rolling over its loan facility for at least 12 months after the reporting date.

A consequent change to Ind AS 10, Events after the Reporting Period, is also proposed to be made, wherein condonation of breach by lender post the reporting date shall not be treated as an adjusting event. The proposed amendments specifies that only covenants with which an entity is required to comply on or before the reporting date should affect the classification of a liability as current or non-current. In addition, ED also provides clarification on the classification of liability that includes a counterparty conversion option that may require the company to settle the liability by issuing its own shares.

Additional disclosures about compliance with future covenants impacting classification are also required to be given. The proposed changes, once approved, shall be applicable for annual reporting periods beginning on or after 1 April 2024 retrospectively. The ED does not permit an early adoption.



Existing requirement under IAS 1 and IND AS 1:

Classification of Liabilities in the financial statements: According to IAS 1, Presentation of Financial Statements, a loan that is payable on demand because a loan condition has been breached is classified as current even if the lender has agreed, after the end of the reporting period but before the financial statements are authorised for issue, not to demand repayment as a result of the breach.

The existing carve-out under (Ind AS) clarifies that the liability is classified as

non-current, if the lender agreed after the end of the reporting period and before the approval of the financial statements for issue, not to demand repayment because of the breach.

Consequent to this carve-out being included in the Ind AS 1, it has been clarified under Ind AS 10 'Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement before the end of the reporting period (balance sheet date) that results in the liability becoming payable on demand, if the lender agrees to condone the breach before the approval of the financial statements for issue, it shall be considered as an adjusting event.

The Ministry of Corporate Affairs (MCA) had originally included the carve-out because of the requirements of the Indian banking system. Usually, the long-term loan agreements executed by Indian banks contain many material/substantive and procedural/non-substantive conditions. Substantive conditions include failure to repay instalment/interest while procedural conditions may include submission of details relating to change in the composition of board of directors. There is generally a business practice between the borrower and the lenders that in case of a procedural breach, loans are generally not recalled. In certain cases, breach may be rectified after the balance sheet date and before the approval of financial statements. The MCA was of the view that where the breach is rectified after the balance sheet date and before the approval of the financial statements, it would be appropriate for the users to be informed about the true nature of liabilities being non-current in nature instead of being classified as current.

Our analysis of the exposure draft:

Removal of Carve-out relating to condonation of breach by the lender

Under existing Ind AS 1, a carve-out was made prescribing that an entity does not classify a liability as current under a long-term arrangement where breach of a material provision has taken place on or before the end of the reporting period but the lender has agreed, after the reporting period and before the approval of the financial statements for issue, to not demand payment because of the condonation of the breach.

As compared to this, IAS 1 requires such a liability to be classified as current because, at the end of the reporting period, the entity does not have the right to defer its settlement for at least twelve months after that date.

We note that the ASB's proposed amendments clarifies that the classification of a liability will depend on existence of the rights at the end of the reporting date. Subsequent events should not impact classification as on the reporting date. This proposed amendment will bring in the consistency between Ind AS 1 and IAS 1 thus eliminating one more area of difference between the two frameworks.

Right to defer settlement should exist at reporting date and should have substance

As per the current requirement, companies classify a liability as current when they do not have an unconditional right to defer settlement for at least 12 months after the reporting date. The proposed amendment removes the requirement for a right to be unconditional and instead now requires that a right to defer settlement must exist at the reporting date and have substance. The ED requires that the classification of liabilities should not be impacted by the company's intention or expectation relating to exercise of its right to defer settlement or choice of early settlement.

We note that the ASB proposed amendment will require all companies to make an assessment at the balance sheet date about the status of its compliance with financial and non-financial covenants. For example if a company is required to maintain a particular inventory level in relation to its borrowing and if such level is breached at the balance sheet date of 31st March, but the date of reporting to the lender is say 31st May, then the Company needs to evaluate and substantiate that the condition in relation to inventory level is not breached on the date of balance sheet otherwise it may have to classify such borrowing as current.

We submit that the ASB provide additional guidance on how 'to have substance' should be interpreted and applied in practice when analysing an unconditional right to defer settlement for at least 12 months after the reporting date.

Classification of Convertible Debt

The proposed changes also provide guidance on how an entity classifies a liability that can be settled in its own equity shares. When a liability provides the holder a conversion option that involves a settlement by way of issue of company's own equity instruments, the conversion option is recognised as either equity or a liability, separately from the host liability as per the requirements of Ind AS 32, Financial Instruments: Presentation. The ED clarifies that for the purpose of classifying the host liability as current or non-current, the company is required to ignore the conversion option that is recognised as equity under Ind AS 32.

This clarification will ensure standardisation in the presentation of such transactions, across companies and sectors. For example, if a company has issued a convertible debt where the conversion option is equity classified and it allows the holder to convert the outstanding debt into equity at any time during the tenure of such debt then one can argue that the debt is redeemable at any point in time and hence should be classified as current. We see diversity in practice wherein some companies classify such debt as current and another set of companies classify such debt as non-current, basis the original maturity of the convertible debt instrument. We welcome this change as this will ensure consistency in classification of such instrument in the financial statements.

Removal of distinction between a material and non-material breach

The existing Ind AS 1 clarifies that the breach should relate to a material provision of a long term arrangement, for a long term loan arrangement to be classified as current. The proposed amendment does away with the distinction between a material and a non-substantive breach.

This is a significant change in the way a breach is looked at by both the borrowers and lenders and companies needs to evaluate the same more carefully and need to put in place robust systems and processes to ensure compliance with all loan covenants at the balance sheet date, otherwise they run the risk of classification of such loan as current in nature.



Disclosure

The following disclosures are proposed:

- information about the covenants and the carrying amount of related liabilities;
- facts and circumstances that indicate the entity may have difficulty complying with the covenants

The following additional disclosures are also required under Ind AS 1, for events occurring after the end of the reporting period and the date on which the financial statements are approved for issue. These events are disclosed as non-adjusting events:

- refinancing on a long-term basis of a liability classified as current;
- rectification of a breach of a long-term loan arrangement classified as current;
- the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement classified as current; and
- settlement of a liability classified as non-current,

The above changes are applicable for accounting periods beginning on or after 1 April 2024 retrospectively, hence companies need to review the impact of these changes immediately as they become effective for comparative financial information, i.e. accounting periods beginning on or after April 1, 2023.

Were the ED to be notified before the approval of the financial statements for the year ended 31 March 2023, disclosure under Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors, may also be required for the possible future impact of these changes.



Our comments and recommendation

Whilst we appreciate the intent of the ASB to align Ind AS 1 with IAS 1, we are of the view that the removal of the carve-out will lead to new concerns and may not result in more relevant information being made available to the users of financial statements. Our comment is based on the following:

Practical business and operating realities

- The carve-out was well thought out when it was originally included as a part of the Ind AS roll-out. The carve-out was considered necessary considering the operational and functional realities that are specific to the Indian business landscape and banking sector. Discussions between lenders and borrowers, especially on matters of covenant breaches, is a time intensive activity in India and hence the borrowing entity may not necessarily receive a condonation of a covenant breach by the reporting date, even though the intent of the lending entity may be to ultimately provide such condonation. In such situations, classifying a debt as current, when such breach would be condoned before the financial statements are authorised for issue, may not result in a fair presentation.
- We see multiple sectors getting negatively impacted by applying the requirements of the ED, such as the infrastructure sector (Power, road and highways, airports and ports), where a very significant portion of initial investment has been financed through external borrowing either from the banking sector domestically or internationally or these are financed by NBFC's.

For example, in India, land mortgage requirements/regulatory approvals are a time-consuming process, and operational complexities vary from state to state. However, the projects availing the funding do commence work in parallel. In most of these cases, lenders take practical approach in continuing to support these projects and the loans are generally not recalled, unless the default pertains to payment of interest or principal. Given India's push to develop its infrastructure, such a move is not well timed and it may impair the ability of the financial institutions to advance loan for such projects and at the same time will impact the company's ability to manage and demonstrate the robustness of its finances and ability to meet its short term and long term payment obligations.

Another example to reiterate this point is the lending by Banks to NBFC's, where during the COVID period when loan repayment moratoriums were provided to the borrowers of the NBFC's, no such moratorium was provided to the NBFC in relation to their liabilities to Bank's. This resulted in a number of NBFC's defaulting on their borrowing covenants, however, in practice there was a very low number of loans to NBFC's which got recalled by the lending Banks and most of the banks waived the requirement for early repayment.

- The change will also vitiate comparability of amounts presented in the financial statements and ratios across reporting periods, as the loan facility may be classified as current

in one period and non-current in another period. This may also have a consequential impact on the costs of raising capital for the company and may show an imbalance in the cash flow generation ability of the Company and outstanding debt to be serviced on a short-term basis.

- The classification may also impact the liquidity-based disclosures presented in the financial statements and indicate an unnecessarily stretched liquidity position of the borrower to the external stakeholders, when in substance the breach has been resolved in a timely manner before the issue of the financial statements.

Guidance under US GAAP aligned with the existing Ind AS requirement for breach of loan covenant

Under US GAAP ASC 470, a debt that is repayable on demand resulting from a breach of covenant is not classified as current if, after the reporting date but before the financial statements are issued, the lender has condoned the violation and it is not probable that the debtor will violate any provision of the debt instrument within 12 months from the reporting date. Thus, this is an acceptable method to classify the loan, as it presents a more updated version of information available at the time of approval of the financial statements.

In conclusion

We are of the view, that the carve-out should not be removed, and support disclosure of the condonation by lender before the management approves the financial statements. We believe that this disclosure of information in the financial statements will enable the users to assess the risk of instances when that liability could become repayable within twelve months. This approach is likely to result in availability of relevant information to the users of the financial statements.

We submit that, an assessment can be made of the factual position (compliance with financial and non-financial covenants) prospectively over a 3 year horizon of instances where the year end reporting is basis the subsequent condonation (after the reporting date but before the issuance of the financial statements) and basis this empirical evidence (after assessing the extent to which such waiver continue to be availed of by borrowers and lenders in the Indian ecosystem) the ASB may take a decision on whether to continue with the carve out or align to IAS 1 in the future.



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