Confederation of Indian Industry

**Exposure Draft**
**Classification of Liabilities as Current or Non-current**
**and**
**Non-current Liabilities with Covenants**
**Amendments to Ind AS 1**

**December 2022**

## Introduction

The Exposure Draft 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 proposes amendments relating to classification of liabilities as current or non-current to resolve apparent contradictions between paragraph 69(d) and paragraph 73 of Ind AS 1. The proposed amendments also specify 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 (paragraph 72A). In this regard, the proposed amendments require disclosure of information that enables users of financial statements to understand the risk that non-current liabilities with covenants could become repayable within twelve months.

While considering the aforesaid amendments to Ind AS 1, the ASB also considered the related aspect of classification of 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 agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment because of the condonation of the breach. Under Ind AS 1, a carve-out was made in paragraph 74 of Ind AS 1 prescribing that an entity does not classify such a liability as current. 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. Consequent to the above mentioned carve-out, paragraph 76 of IAS 1 was not included in Ind AS 1 and changes were made in Ind AS 10, Events After the Reporting Period, also. The ASB considered the said carve-out and proposed to remove to the same.

In view of the above, the ASB invited comments on specific question *'Do you agree with removal of the carve-out made in paragraph 74 of Ind AS 1? If not, why?'* as well as on any aspect of the Exposure Draft.

**Rationale of ASB for the proposed amendments**

I. The Standard prescribes the classification of liabilities as current or non-current based on whether it has right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period (paragraph 69(d)). This principle has been further clarified in the proposed amendments that classification of a liability will depend on existence of the right at the end of the reporting date. Subsequent events, such as, intention or expectation of the management to settle the liability within twelve months after the reporting period or actual settlement between the end of the reporting period and the date the financial statements are approved for issue, will not affect the classification. However, the entity may need to disclose information about the timing of settlement to enable users of its financial statements to understand the impact of the liability on the entity's financial position. Accordingly, in view of the proposed amendments, the existing carve-out is not conceptually aligned with the other prescriptions of the Standard for classification of liabilities as current or non-current.

II. While certain carve-outs were made to smoothen the transition to Ind AS, it was intended that since the objective is to achieve convergence with IFRS Accounting Standards over a period of time, the carve-outs shall be reviewed from time-to-time once Ind AS implementation gets stabilised in India. Accordingly, since 6 years of Ind AS implementation have already elapsed, the ASB considered it appropriate to remove this carve-out.

III. Removal of the carve-out will be a step towards bringing greater financial discipline amongst the entities since a breach of a loan covenant even if subsequently condoned by a lender signifies an inherent weakness in the financial condition of an entity.

**CII Submissions**

**In consultation with members and basis inputs received, CII submission is as below.**

The industry broadly welcomed the proposed narrow-scope amendments in this Exposure Draft including right to defer settlement for at least twelve months (paragraph 69(d) for a liability to be classified as non-current and the related clarification in new paragraph 72B for compliance with conditions specified in the loan agreement which affect or do not affect such right.

However, the following concerns with other aspects of the proposals in the Exposure Draft have been highlighted:

- ***Requirement for the right to have "substance"***

  Proposed new paragraph 72A requires that an entity's right to defer settlement of a liability for at least twelve months after the reporting period must have "substance". However, the ED does not provide additional guidance on how an

entity assesses whether its right has substance. Therefore, guidance is required on how an entity assesses appropriately and consistently whether its right to defer settlement has substance. Absence of guidance may result in diversity due to different interpretations. One may also argue that the classification based on 'substance' requirement can override the classification based on paragraph 72B.

- ***Removal of the carve out in paragraph 74***
  The removal of the carve out has its own merits and demerits which require a careful consideration.

  <u>*Arguments in favour of removal of the carve out*</u>
  - The removal of the carve out will result in the classification being aligned with the strict application of the definition of current and non-current liability as well as adjusting and non – adjusting post balance sheet event.

  - Breach of a loan covenant may have implications for liquidity position of the company and/or its operational challenges and/or its state of governance. If a breach exists at the reporting date, its implications should be appropriately reflected in the financial statements (including classification as a current liability) so that relevant information is available to the users of the financial statements for their decision making and can also be appropriately reflected in its fair value/market price. At present, in view of the carve out, a user of financial statements may not even be aware of the breach especially considering that no disclosures are made in this regard. The proposed classification will encourage financial discipline as well as good governance.
  - Any breach of debt covenant after the reporting date does not impact the classification of liability. The removal of the crave out will result in parity in treatment of post balance events before approval of the financial statements for a new breach and for condonation of existing breach of a loan covenant.
  - It will also converge the standard with the corresponding IAS 1 in this regard.

  <u>Arguments in favour of retaining the carve out</u>
  - The practice in India relating to the nature and extent of loan covenants is somewhat peculiar since the loan agreements have a large number of covenants for which a breach can technically result in the loan becoming repayable. However, in practice, many of these covenants (including those relating to delays in submission of specified documents) are intended to ensure discipline by the company and generally the right to recall the loan is not exercised for such covenants. The lender generally condones the breach for such covenants and the right to recall the loan is exercised in limited situations (usually where the default pertains to payment of interest or principal). Quite often the condonation of a covenant breach is finalized after the reporting date primarily due to time consuming discussions between lenders and borrowers even though the intent of the lender may be to ultimately provide such condonation. The classification of liability as non-current at the reporting date

would not be inappropriate considering that 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.

In case the liability is classified as a current liability at the reporting date and the notes to the financial statements state that the breach has been condoned by the lender, it can be confusing for the reader of the financial statements as to whether to consider this as current or non-current for their analysis. This can result in each reader making its own assessment which may also differ. Our understanding is that analysts will usually consider this as a non-current liability in their analysis. Considering this, the classification of the loan as a non-current liability (where 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) would provide more relevant information and may be continued.

- The removal of the carve out will adversely impact comparability of amounts presented in the financial statements and ratios - the loan will be classified as current in one period and non-current in the next period – even though for all practical purposes it will be considered as non-current.
- While classification as a current liability may be in strict compliance with the definition of current liability, it may not reflect the ground reality.
- The carve-out was based on operational and functional realities specific to the Indian business landscape and banking sector. The experience in the past in India indicates that the carve out has been working well.

*Overall*

It is requested that the ASB to do an analysis of the interaction of waivers/condonations by the lenders with the instances of going concern and insolvency. For example, how often do companies, which have received condonations of breach of loan covenant, have a going concern issue or end up in insolvency. A higher correlation may be supportive of current classification of liability.

In view of the arguments stated earlier and subject to the outcome of the above analysis, a balanced approach in the short term can be to continue with the carve out. However, this should be necessarily accompanied by relevant disclosures regarding the nature and extent of default. The disclosure of information in the financial statements will provide relevant information to the users of the financial statements and enable them to assess the risk of instances when that liability could become repayable within twelve months. This will also encourage good governance, financial discipline and ensure that the breach is considered appropriately in decision making and/or in valuations.

It will also be helpful if the application of the requirements is explained through implementation guidance. For example, in practice, an entity may be required to comply with conditions at various dates throughout the year (e.g., annually, semi-

annually, or quarterly). For a breach of covenants at the reporting date (say, 31 March 2023), the lender grants a waiver in May 2023 (prior to approval of financial statements). However, the lender retains its right to call the loan if the covenants are not met at the next testing date (say, 30 June 2023). One may argue that as a result, the situation is one where the entity is required to comply with specified conditions after the reporting date (and would present the liability as non-current under proposed paragraph 72B(b)). However, it appears that the liability should be presented as current since, strictly, the waiver obtained does not provide a grace period of at least twelve months.

From a longer-term perspective, the Board may consider a broader rethink of the fundamental principle of the classification of liabilities (as current or non-current). More specifically, the relevance of the concept considering the disclosures required by other standards (e.g., Ind AS 107).

- ***Disclosures***
  - The specific disclosures included in the proposals for non-current liabilities are widely supported subject to conditions. However, for its effective implementation in practice, the Board may explain how these proposed disclosures interact with/complement other IFRS disclosure requirements – e.g., liquidity risk disclosures in Ind AS 107 Financial Instruments: Disclosure or Ind AS 1 going concern disclosures. Instead of repetition of disclosures, it will be helpful for the readers if the disclosures are given in one place in the notes to the financial statements. In the absence of any basis for conclusion section in Ind AS, this may be done as part of educational material on implementation of the amendments.
  - Additional disclosures in paragraph 76ZA(b)

    It is not clear whether the proposed disclosures would only apply for 'term loans' but not for 'roll-over facilities' discussed in the current paragraph 73 of Ind AS 1. Given that these arrangements are economically similar, our understanding is that the proposed disclosures would be applicable for both. This may be suitably clarified.

    It may also be clarified whether the proposed disclosures would apply to entities that prepare their balance sheet based on the order of liquidity as per Ind AS 1. We request the Board to clarify the position in this regard.

Above submissions may be considered in finalising the proposed amendments.

For consideration, please.

***