HKFRS / IFRS UPDATE 2023/01

Updated October 2023

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AMENDMENTS TO HKAS/IAS 1 – NON-CURRENT LIABILITIES WITH COVENANTS

STATUS

Final

EFFECTIVE DATE

1 January 2024

ACCOUNTING IMPACT

The Amendments address the concerns raised by stakeholders on the effects of the amendments to HKAS/IAS 1 *Classification of Liabilities as Current or Non-current* related to classification of liabilities with covenants. Under the 2022 Amendments, a covenant affects whether right to defer settlement exists at the end of the reporting period if compliance with the covenant is required on or before the end of the reporting period.

BACKGROUND

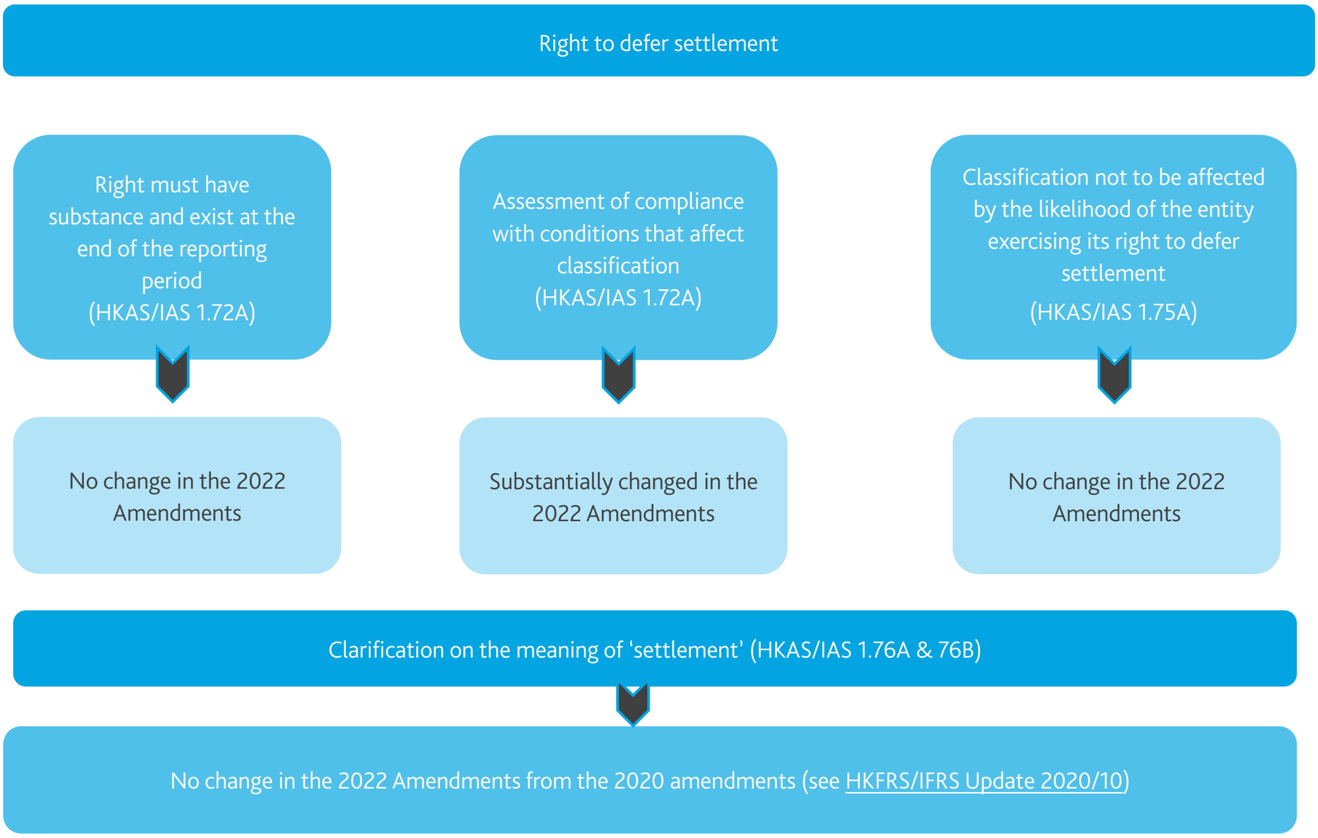
On 31 October 2022, the IASB issued amendments to IAS 1 – *Non-current Liabilities with Covenants* ('the Amendments' or 'the 2022 Amendments').

In January 2020, the IASB issued amendments to IAS 1 – *Classification of Liabilities as Current or Non-current* (the 2020 Amendments). The HKICPA has published the equivalent amendments to HKAS 1. One of the requirements prescribed by the 2020 Amendments related to the classification of liabilities subject to covenants (eg a bank loan where the lender may demand accelerated repayment if financial covenants are not met). The 2020 Amendments provided that if an entity's right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. Several concerns were raised about the outcome of these requirements, therefore, the mandatory effective date was deferred. In order to address these concerns, the IASB has now issued the 2022 Amendments. The HKICPA published the equivalent amendments to HKAS 1 on 15 December 2022. At the same time, the HKICPA has updated HK Interpretation 5 (Revised) – *Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause* (HK Int 5) to incorporate the references to these amendments and assessed the effects of these amendments when they are applied as a package on the conclusions in HK Int 5. The HKICPA concluded that these amendments do not change the conclusions in HK Int 5.

The 2022 Amendments specify that covenants to be complied with after the reporting date do not affect the classification of debt as current or non-current at the reporting date. An entity is required to disclose information about these covenants in the notes to the financial statements.

THE 2020 AMENDMENTS

This diagram summarises the changes made to the 2020 Amendments by the 2022 Amendments:



BDO issued HKFRS/IFRS Update 2020/10 – *IASB Issues Amendments to IAS 1 – Classification of Liabilities as Current or Non-current* that explains the 2020 Amendments. Please refer to HKFRS/IFRS Update 2020/10 for the 2020 Amendments that have not been further modified by the 2022 Amendments.

What did the 2020 Amendments require that has been amended by the 2022 Amendments?

The 2020 Amendments inserted paragraph 72A which stated as below (emphasis added):

> *An entity's right to defer settlement of a liability for at least 12 months after the reporting period must have substance and, as illustrated in paragraphs 73–75, must exist at the end of the reporting period. If the right to defer settlement is subject to the entity complying with specified conditions,* ***the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period.*** *The entity must comply with the conditions at the end of the reporting period* ***even if the lender does not test compliance until a later date.***

In response to the feedback received from stakeholders on the 2020 Amendments, in December 2020, the IFRS Interpretations Committee (the Committee) issued a Tentative Agenda Decision (TAD) that analysed the applicability of the 2020 Amendments to three fact patterns.

In its analysis, the Committee noted that the entity's expectation in each of the three fact patterns that it will meet the condition tested after the reporting period does not affect its assessment of the criterion in IAS 1.69(d). The Committee further noted that applying IAS 1.69(d) and IAS 1.72A, the entity's right to defer settlement of a liability for at least 12 months after the reporting period must exist at the end of the reporting period.

A practical implication of this requirement is that a covenant that will be tested in the future (eg a 30 June 20X4 covenant for an entity with a 31 December 20X3 reporting period end) would need to be 'notionally tested' as at the reporting period end (31 December 20X3). The entity would only be permitted to classify the loan as non-current if it would comply with the 30 June 20X4 covenant as at 31 December 20X3, despite the fact that the 30 June 20X4 covenant does not contractually apply as at period end.

The Committee concluded that the entity is required to classify the loan as current because in the fact pattern described, the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least 12 months after the reporting period.

Most respondents to the TAD agreed (or did not disagree) with the Committee's technical analysis. However, several concerns were raised about the outcome of applying these requirements, including the following:

- *Seasonality and expectation of future performance incorporated in the covenants not considered:*

  Often covenants are designed incorporating the effects of seasonal nature of business and expectations of entity's future performance. In such cases, an entity may not meet a covenant at period end if the covenant is designed to be met and tested subsequently. However, the 2020 Amendments would require an entity to meet the covenant at period end for classification of liability as current, even though the lender may not expect the covenant to be met then.

- *Possibility of fluctuations in financial statements:*

  The 2020 Amendments required covenants to be met at every period end, including interim periods, for a classification of the liability as current. Especially in case of businesses with a seasonal nature, it may so happen that a covenant is not met in one period end but is met in the subsequent period end. As a result, classification of the liability could continue alternating between current and non-current, leading to fluctuations in the financial statements with little information value.

- *Treatment in case of cumulative covenants not clear:*

  The 2020 Amendments did not provide sufficient guidance on how the requirements should be applied to conditions relating to the entity's cumulative financial performance such as profit and turnover.

Refer BDO's Comment Letter on the TAD here.

Considering the comments received and the concerns raised, the Committee decided not to finalise the TAD and referred the matter to the IASB.

THE 2022 AMENDMENTS

After considering the feedback from stakeholders, the IASB decided to undertake an amendment to IAS 1. The IASB issued an Exposure Draft of the proposed amendment in November 2021, for which the comment period ended on 21 March 2022. The final Amendments were issued on 31 October 2022. The HKICPA published the equivalent amendments to HKAS 1 on 15 December 2022.

What are the key amendments?

There are two key changes made by the Amendments, apart from additional disclosure requirements.

1. Amendment to HKAS/IAS 1.72A

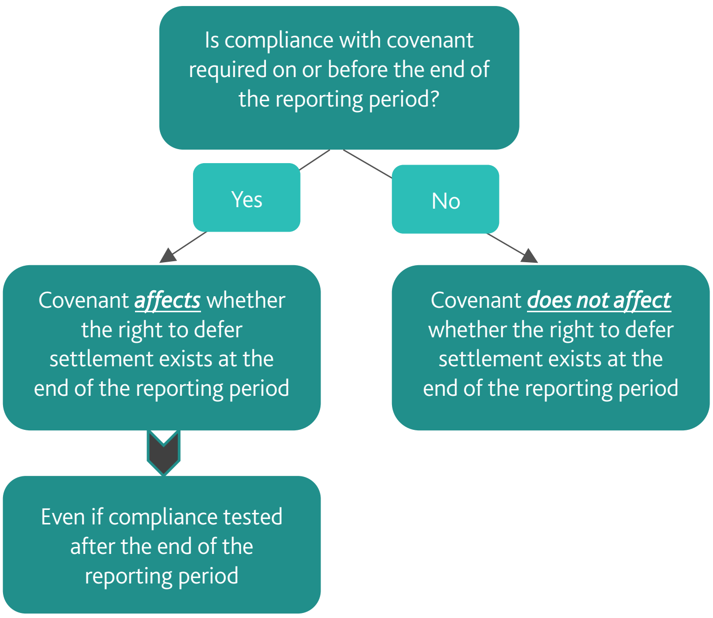
The requirement pertaining to the entity's right to defer settlement being subject to conditions is deleted.

Now the amended paragraph 72A of HKAS/IAS 1 reads as below:

*An entity's right to defer settlement of a liability for at least 12 months after the reporting period must have substance and, as illustrated in paragraphs 72B-75~~73–75~~, must exist at the end of the reporting period. ~~If the right to defer settlement is subject to the entity complying with specified conditions,~~ ~~**the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period**~~. ~~The entity must comply with the conditions at the end of the reporting period~~ ~~**even if the lender does not test compliance until a later date.**~~*

2. Insertion of HKAS/IAS 1.72B

The Amendments added paragraph 72B which specify the requirements in cases where the entity's right to defer settlement of a liability arising from a loan arrangement for at least 12 months after the reporting date is subject to the entity complying with covenants. The requirements of HKAS/IAS 1.72B are:



The Amendments also add paragraph 76ZA which sets out disclosure requirements for situations where an entity classifies liabilities arising from loan arrangements as non-current when the entity's right to defer settlement of those liabilities is subject to the entity complying with covenants within 12 months after the reporting period. In such situations, HKAS/IAS 1.76ZA requires the entity to disclose information in the notes that enables users of financial statements to understand the risk that the liabilities could become repayable within 12 months after the reporting period, including:

a) information about the covenants and the carrying amount of related liabilities;

b) facts and circumstances, if any, that indicate the entity may have difficulty complying with the covenants.

Implications of the Amendments

The Amendments address many of the concerns raised on the 2020 Amendments and the TAD.

The following examples illustrate the application of the amended requirements, however, in some cases, the same conclusions may have been reached prior to the amendments. The annual reporting period end in all the following examples is 31 December:

Example 1: Covenants to be tested based on issued, audited financial statements

Entity A has a long-term bank loan repayable after five years. The loan requires Entity A to have a working capital ratio above 1.1 as at every annual period end ie 31 December, failing which the loan becomes repayable on demand. The covenant is assessed based on the audited financial statements that are required to be provided to the bank by 31 March of the following year.

On 31 December 20X1, the working capital ratio is 1. Entity A expects the working capital ratio to be 1.15 by 31 March 20X2.

How will Entity A classify the loan on 31 December 20X1?

Analysis:

As required by HKAS/IAS 1.72B, covenants affect whether the right to defer settlement for at least 12 months after the reporting date exists at the end of the reporting period if an entity is required to comply with the covenant on or before the end of the reporting period. This is the case even if compliance with the covenant is assessed only after the reporting period.

In this example, Entity A is required to comply with the covenant on 31 December even though the compliance is assessed by 31 March of the subsequent year. Therefore, the covenant affects whether the right to defer settlement exists at the end of the reporting period.

Entity A's working capital ratio on 31 December 20X1 is 1, which is below the required ratio of 1.1.

Therefore, Entity A does not have the right at the end of the reporting period to defer settlement of the liability for at least 12 months after the reporting period (HKAS/IAS1.69(d)). Therefore, the liability is classified as current.

Example 2: Waiver provided for the breach of covenant before the reporting date

Assume a similar fact pattern as in Example 1, except the following.

Entity A obtain a waiver from the bank for the breach of covenant before the reporting date i.e. 31 December 20X1.

The waiver is for three months. Compliance with the covenant will be assessed based on the interim financial statements for Q1 20X2.

Entity A expects the working capital ratio to be above 1.1 on 31 March 20X2.

How will Entity A classify the loan on 31 December 20X1?

Analysis:

HKAS/IAS 1.74-75 states (emphasis added):

> HKAS/IAS 1.74:
>
> *When an entity **breaches** a covenant 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, it **classifies the liability as current**, **even if the lender agreed, after the reporting period** and before the authorisation 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.

HKAS/IAS 1.75:

*However, an entity classifies the liability as **non-current** if the **lender agreed by the end of the reporting period** to provide a **period of grace** ending at least **twelve months after the reporting period**, within which the entity can **rectify the breach** and during which the lender cannot demand immediate repayment.*

HKAS/IAS 1.74-75 apply in cases where a breach has occurred, and the lender provides a waiver before or after the end of the reporting period.

In this case, the covenant requires Entity A to have a working capital ratio of 1.1 as at 31 December. Entity A, in anticipation of a breach on 31 December 20X1, obtains a waiver from the bank before 31 December 20X1. Therefore, the covenant is not breached as at 31 December 20X1, as it has already been waived as a result of the lender waiving its rights with respect to the anticipated violation.

Therefore, HKAS/IAS 1.75 does not apply to this case.

Compliance with the covenant will now be tested based on the interim financial statements for Q1 20X2, which is a future covenant test.

As per HKAS/IAS 1.72B(b), if an entity is required to comply with the covenant only after the reporting period, the covenant does not affect whether the right to defer settlement for at least twelve months after the reporting period exists at the end of the reporting period. Therefore, the liability will be classified as non-current as at 31 December 20X1.

Example 3: Covenant to be met after the end of the reporting period – expected to be met

Entity B has a bank loan for a period of seven years. The contract includes a covenant that requires a current ratio above 1.2 on 30 June every year. The loan will be repayable on demand if the covenant is not met.

Entity B's current ratio on various dates is as below:

31 December 20X3	1.15
30 June 20X4 (expected ratio)	1.25

How will Entity B classify the loan on 31 December 20X3?

Analysis:

Entity B is required to comply with the covenant after the reporting period. Therefore, as per HKAS/IAS 1.72B(b), the covenant does not affect whether the right to defer settlement for at least 12 months after the reporting period exists at the end of the reporting period.

Therefore, assuming that the covenant was met on 30 June 20X3, Entity B classifies the loan as non-current as at 31 December 20X3.

As required by HKAS/IAS 1.76ZA, Entity B will be required to disclose information that enables users of financial statements to understand the risk that the liabilities could become repayable within 12 months after the reporting period.

Example 4: Covenant to be met after the end of the reporting period – not expected to be met

Entity B has a bank loan for a period of seven years. The contract includes a covenant that requires a current ratio above 1.2 on 30 June every year. The loan will be repayable on demand if the covenant is not met.

Entity B's current ratio on various dates is as below:

30 June 20X1	1.22
31 December 20X1	1.15
30 June 20X2 (expected ratio)	1.05

How will Entity B classify the loan on 31 December 20X1?

Analysis:

As provided by HKAS/IAS 1.72B(b), covenants do not affect whether the right to defer settlement exists at the end of the reporting period if an entity is required to comply with the covenant only after the reporting period.

In this example, Entity B has met the covenant on 30 June 20X1 and therefore, the loan is not repayable on demand on 31 December 20X1.

Entity B is required to comply with the covenants next on 30 June 20X2, which is after the current reporting period. Therefore, this covenant compliance does not affect the determination of whether the right to defer settlement exists at the end of the reporting period and the loan will be classified as non-current.

The expectation that the covenant will not be met at the date of assessment subsequent to the reporting period does not have an effect on the determination of the classification of the liability on the reporting date.

As required by HKAS/IAS 1.76ZA, Entity B will be required to disclose information that enables users of financial statements to understand the risk that the liabilities could become repayable within 12 months after the reporting period. Entity B will need to disclose facts and circumstances that indicate that it may have difficulty complying with the covenants.

Example 5: Covenant not met in the current year, expected to be met in the next year

Entity C has a five-year bank loan. The loan includes a covenant that requires a working capital ratio above 1 at each 30 June. The loan will be repayable on demand if the covenant is not met.

Entity C's current ratio on various dates is as below:

30 June 20X1	0.85
31 December 20X1	0.90
30 June 20X2 (expected ratio)	1.05

How will Entity C classify the loan on 31 December 20X1?

Analysis:

As the covenant is not met on 30 June 20X1, the loan is currently repayable on demand.

As of 31 December 20X1, Entity C does not have the right to defer settlement for at least 12 months. Therefore, as required by HKAS/IAS 1.69(d), the loan needs to be classified as current.

As HKAS/IAS 1.72B(b) requires, covenants that an entity is required to comply with after the reporting period do not affect whether the right to defer settlement exists at the end of the reporting period. The expectation that the covenant will be met on 30 June 20X2, which is the next covenant assessment date, does not affect the classification of the liability as current on 31 December 20X1.

If the loan is outstanding on 30 June 20X2 and the covenant is met, the loan will be classified as non-current as at 30 June 20X2, assuming the covenant violation as at 31 December 20X1 no longer gives rise to a right for the lender to demand immediate repayment.

Effective date

The Amendments are effective for annual reporting periods beginning on or after 1 January 2024 retrospectively in accordance with HKAS/IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies the 2022 Amendments for an earlier period, it shall also apply the 2020 Amendments for that period.

The 2022 Amendments have also changed the effective date of the 2020 Amendments. If an entity applies the 2020 Amendments for an earlier period after the issue of the 2022 Amendments, is shall also apply the 2022 Amendments for that period.

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