Issue 209 / November 2022

The IASB amends the requirements for classification of non-current liabilities with covenants

What you need to know

- In October 2022, the IASB issued amendments that clarify that only covenants with which an entity must comply on or before the reporting date will affect a liability's classification as current or non-current.
- Additional disclosures are required for non-current liabilities arising from loan arrangements that are subject to covenants to be complied with within twelve months after the reporting period.
- The amendments will be effective for annual reporting periods beginning on or after 1 January 2024, with early application permitted.

Highlights

In October 2022, the International Accounting Standards Board (the IASB or the Board) issued amendments to IAS 1 *Presentation of Financial Statements*. The amendments are based on those originally set out in the Exposure Draft ED/2021/9 *Non-current Liabilities with Covenants, Proposed Amendments to IAS 1* (the ED). In the amendments, the Board clarifies that only covenants with which an entity must comply on or before the reporting date will affect a liability's classification as current or non-current.

Background

In January 2020, the IASB issued amendments to paragraphs 69 to 76 of IAS 1 (the 2020 amendments) to specify the requirements for classifying liabilities as current or non-current. A key requirement of the 2020 amendments was that entities with liabilities that are subject to covenants to be complied with at a date subsequent to the reporting period ("future covenants") do not have the right to defer settlement of the liabilities at the end of the reporting period if they do not comply with the covenants at that date.

Stakeholders were concerned about the impact of this proposal and, as a result, the IFRS Interpretations Committee (the Committee) published a tentative agenda decision (TAD) in December 2020 explaining how to apply the proposal to three fact patterns. The Committee agreed with the concerns raised in comment letters responding to the TAD about the consequences of the 2020 amendments for certain scenarios and reported them to the Board. On that basis, the Board proposed amendments in November 2021, which, after further adjustments, resulted in the amendments issued in October 2022 (the 2022 amendments).

Building a better working world

The Board concluded that the amended classification requirements will provide useful information when considered together with the requirements to disclose information about non-current liabilities with future covenants in the notes.

The 2022 amendments

Under the 2022 amendments, only covenants of a liability arising from a loan arrangement, which an entity must comply with on or before the reporting date affect the classification of that liability as current or non-current. The amendments are linked to the requirements on disclosure about such liabilities. The IASB concluded that the amended classification requirements will provide useful information when considered together with the requirements to disclose information about non-current liabilities with future covenants in the notes.

Separarate presentation

The 2022 amendments, as opposed to the proposed amendments in the 2021 ED, do not require an entity to present separately non-current liabilities for which the entity's right to defer settlement is subject to compliance with future covenants within twelve months. Instead, the 2022 amendments require entities to disclose information about such covenants and related liabilities in the notes.

Disclosures

The 2022 amendments require an entity to provide disclosure when a liability arising from a loan agreement is classified as non-current and the entity's right to defer settlement is contingent on compliance with future covenants within twelve months. This disclosure is required to include information about the covenants and the related liabilities. The disclosures must include information about the nature of the future covenants and when compliance is applicable, as well as the carrying amount of the related liabilities. The purpose of this information is to allow users to understand the nature of the future covenants and to assess the risk that a liability classified as non-current could become repayable within twelve months. Furthermore, if facts and circumstances indicate that an entity may have difficulty in complying with such covenants, those facts and circumstances must be disclosed. For example, mitigating actions taken by the entity before or after the reporting period might be relevant to disclose as such facts and circumstances. Similarly, if the entity had not complied at the end of the reporting period with such future covenants, then disclosure of that fact might be appropriate.

Right to defer settlement

In the 2021 ED, the Board proposed to clarify what is meant by a right to defer settlement in paragraph 69(d) and the scope of the proposed requirements in paragraph 72B. Among other things, the ED introduced a notion of an event or outcome being 'unaffected by the entity's future actions' to clarify situations in which an entity would not have a right to defer settlement of a liability. However, the feedback received suggested that the proposal would not achieve its objective. Therefore, the IASB decided, instead, to specify that the requirements in paragraph 72B apply only to liabilities arising from loan arrangements.

The 2020 amendments

Several of the 2020 amendments are not impacted by the 2022 amendments, of which two are summarised below.

A requirement was added to clarify that the 'classification of a liability is unaffected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting period' (paragraph 75A). That is, management's intention to settle in the short run does not impact the classification. This applies even if settlement has occurred when the financial statements are authorised for issuance.

The Board also added two new paragraphs (paragraphs 76A and 76B) to IAS 1 to clarify what is meant by 'settlement' of a liability. The Board concluded that it was important to link the settlement of the liability with the outflow of resources from the entity. Settlement by way of an entity's own equity instruments is considered settlement for the purpose of classification of liabilities as current or non-current, with one exception. If, and only if, the conversion option itself is classified as an equity instrument would settlement by way of own equity instruments be disregarded when determining whether the liability is current or non-current.

For further information on the 2020 amendments, see *IFRS Developments Issue 159: Amendments to classification of liabilities as current or non-current* (Updated July 2020).

What's new compared to the current IAS 1

The main changes from current IAS 1 due to the 2020 amendments and 2022 amendments are set out below:

- *Right to defer settlement* - the amendments provide clarification that if an entity's right to defer settlement of a liability is subject to the entity complying with future covenants, the entity has a right to defer settlement of the liability even if it does not comply with those covenants at the end of the reporting period (See 'The 2022 amendments' above).
- *Expected deferrals* - the amendments clarify that classification of a liability is unaffected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting period (See 'The 2020 amendments' above).
- *Settlement by way of own equity instruments* - the amendments clarify that there is an exception to the requirement that settlement of liabilities by way of own equity instruments impacts the classification of liabilities (see 'The 2020 amendments' above).
- *Disclosures* - the amendments require additional disclosures by an entity that classifies liabilities arising from loan arrangements as non-current when it has a right to defer settlement of those liabilities that are subject to the entity complying with future covenants within twelve months (See 'The 2022 amendments' above).

Transition and effective date

The amendments will be effective for annual reporting periods beginning on or after 1 January 2024 and will need to be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Early adoption is permitted, but will need to be disclosed.

The effective date of the 2020 amendments is accordingly delayed, from reporting periods beginning on or after 1 January 2023 to reporting periods beginning on or after 1 January 2024. Early application of the 2020 amendments is permitted. However, an entity that applies the 2020 amendments early is also required to apply the 2022 amendments, and vice versa.

How we see it

The combined impact of the 2020 amendments and the 2022 amendments will have implications for practice. Entities will, therefore, need to carefully consider the impact of the amendments on existing and planned loan agreements. In this context, it is important to highlight that the amendments must be applied retrospectively.

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