

Dialogue with standard setters

Amendments to IAS 1 regarding non-current liabilities with covenants

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Abstract

The International Accounting Standards Board (IASB) in January 2020 issued “Classification of Liabilities as Current or Non-current”, which amended IAS 1 Presentation of Financial Statements. The main purpose of the amendments regards the classification of financial liabilities and how to classify them under particular circumstances. The amendments are proposed to be effective for annual reporting periods beginning on or after 1 January 2023, with earlier application permitted.

Due to feedback received and enquiries about the classification of financial liabilities with financial covenants, in December 2020 the IFRS Interpretations Committee (IFRIC) published a tentative agenda decision in response to such feedback. Subsequently, in October 2022 the International Accounting Standards Board (IASB) published a document titled “Non-current Liabilities with Covenants (Amendments to IAS 1)”. The purpose of this document is to clarify the conditions with which an entity must comply within twelve months after the reporting period affect the classification of a liability. The amendments are effective for reporting periods beginning on or after 1 January 2024.

The classification of financial liabilities as current or non-current is an important consideration for financial reporting purposes, as it can have a significant impact on a company’s financial statements and financial ratios. Current liabilities are those that are expected to be settled within one year, while non-current liabilities are those that are expected to be settled beyond that time frame.

The purpose of the following review is to analyse the main impacts of the amendments on the classification of the financial liabilities with covenants and the project’s history and timeline.

Keywords: IAS 1, liabilities, presentation, current/non current, financial covenants.

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1. IAS 1 requirements regarding current/non current distinction

IAS 1 Presentation of Financial Statements requires that entities distinguish between current and non-current liabilities on their balance sheet.

Current liabilities are those that are expected to be settled within the entity's normal operating cycle, or within twelve months from the balance sheet date, whichever is longer. Examples of current liabilities include accounts payable, short-term loans, and accrued expenses.

Non-current liabilities, on the other hand, are those that are not expected to be settled within the entity's normal operating cycle or within twelve months from the balance sheet date. Examples of non-current liabilities include long-term loans, bonds payable, and pension liabilities.

The distinction between current and non-current liabilities is important because it provides information about the liquidity and financial health of an entity. Current liabilities are generally considered to be more pressing and require more immediate attention, while non-current liabilities represent longer-term obligations that may not require immediate attention. The preparers are often focused on the presentation as current or non-current for the financial liabilities (e.g. derivative financial liabilities, financial loans, bonds, ...) however these requirements should also be applied to all the liabilities such as Provisions within the scope of IAS 37 (e.g. provisions, lawsuits, certain warranty provisions), tax liabilities (within the scope of IAS 12), lease liabilities in accordance to IFRS 16, contract liabilities within the scope of IFRS 15 and cash-settled share-based payment liabilities within the scope of IFRS 2.

IAS 1 requires a company to classify a liability as non-current only if the company has a right to defer settlement of the liability for at least 12 months after the reporting date (right to defer settlement). Without this right, the company might be unable to avoid having to repay the liability within 12 months of its reporting date.

The four criteria indicated by IAS 1.69 (before 2020 and 2022 amendments) in order to classify a liability as current are:

- (a) it expects to settle the liability in its normal operating cycle;
- (b) it holds the liability primarily for the purpose of trading;

- (c) the liability is due to be settled within twelve months after the reporting date;
- (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

2. Impact of financial covenants on the classification of financial liabilities

Financial covenants are contractual agreements between a borrower and a lender that require the borrower to meet certain financial performance criteria. These covenants are designed to protect the lender's investment by ensuring that the borrower has the financial resources to meet its obligations under the loan agreement.

Financial covenants typically include metrics such as debt-to-equity ratio, debt service coverage ratio, minimum liquidity requirements, and maximum leverage ratios. For example, a debt-to-equity covenant might require that the borrower maintain a certain ratio of debt to equity in order to remain in compliance with the loan agreement. A debt service coverage covenant might require that the borrower generate enough cash flow to cover its debt service obligations.

Financial covenants are common in many types of loans, including commercial real estate loans, corporate loans, and project finance loans. They are designed to provide lenders with a level of protection against borrower default by requiring ongoing financial performance monitoring and ongoing compliance with specific financial metrics.

If the borrower fails to meet one or more of the financial covenants, the lender may have the right to declare a default and take action to protect its investment. This could include accelerating the loan, demanding repayment in full, or taking possession of collateral.

The breach of financial covenants can have a significant impact on the classification of financial liabilities. Financial covenants are conditions that borrowers must meet in order to maintain compliance with the terms of their loans or other financial arrangements. These conditions are typically related to the borrower's financial performance and can include requirements for

maintaining certain levels of financial ratios, such as debt-to-equity or interest coverage ratios.

If a borrower breaches a financial covenant, this can trigger a default under the loan agreement or other financial arrangement. In such cases, the lender may have the right to accelerate the repayment of the loan or take other enforcement actions, which could result in the financial liability being reclassified as a current liability. In general, a financial liability that is in breach of a financial covenant and subject to acceleration or other enforcement action by the lender will be classified as a current liability, even if the borrower expects to be able to cure the breach within the next reporting period. This is because the breach of the covenant has created a right for the lender to demand repayment within the next year. It is important for companies to carefully monitor their compliance with financial covenants.

Accordingly, IAS 1.74 indicates that when an entity breaches a covenant of a long-term loan arrangement on or before the end of the financial year, it classifies the liability as current unless the lender agreed to not apply the provision (i.e. not demanding the payment of the loan) usually through a waiver. A waiver in the case of a breach of financial covenant is requested by the borrower and it is typically sought when the borrower is experiencing financial difficulties or is unable to fulfill certain obligations as specified in the loan agreement: the lender may waive specific financial or operational covenants temporarily if the borrower is unable to meet them due to unforeseen circumstances.

It's important to note that a waiver does not release the borrower from their overall obligation to repay the loan. Instead, it provides temporary relief of the application of the financial covenant flexibility regarding certain aspects of the loan arrangement. The specific terms of the waiver, including its duration and any conditions attached to it, should be clearly defined and agreed upon by both parties in a written document or an amendment to the original loan agreement.

3. First proposal of amendment to IAS 1 (2020)

In January 2020 the International Accounting Standards Board issued amendments to IAS 1 Presentation of Financial Statements, to clarify its

requirements for the presentation of liabilities in the statement of financial position.

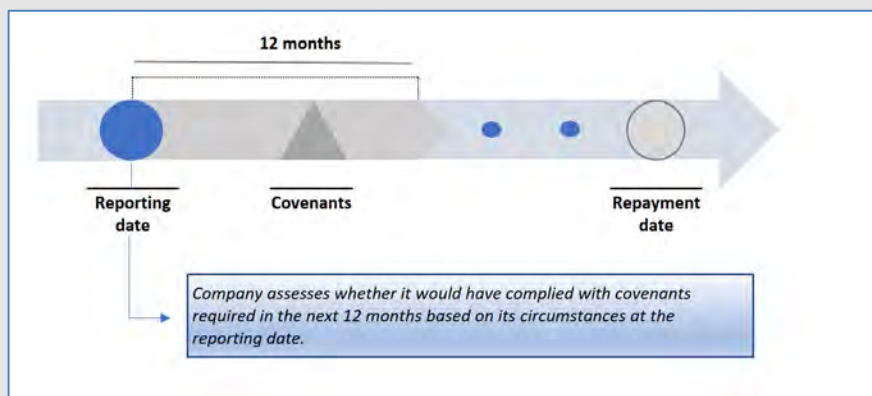
The amendments modify one of the criteria in IAS 1 that results in a liability being classified as current. Any of the criteria being satisfied results in the liability being classified as current. The first three criteria required by IAS 1.69 are unchanged, and require an entity to classify a liability as current when:

- (a) it expects to settle the liability in its normal operating cycle;
- (b) it holds the liability primarily for the purpose of trading;
- (c) the liability is due to be settled within twelve months after the reporting date.

The main proposed change is regarding the fourth requirement required by IAS 1.69(d) that has been amended such that if an entity does not have “the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period” then it must be classified as current. This means as described in Table 1 that, even if the entity is fully compliant at the reporting date, but in the next twelve months after the reporting date it could not respect the financial covenants, therefore the liability is required to be classified as a current liability, because it can be classified as long only if the entity has the right to defer its settlement for at least twelve months, regardless of the entity’s intention.

Applying the 2020 amendments it would mean that the entity should have complied not only at the reporting date but within 12 months after such date.

Table 1 – Proposed 2020 amendment



The main concerns raised by the stakeholders and preparers were to classify a liability as current even when, at the reporting date, it has no contractual obligation to repay the liability within 12 months. The stakeholders' feedback and concern was that such requirement could have significantly increased the risk of classify as current liabilities a significant portion of financial liabilities with maybe the result of lenders who may have the right to declare a default and take action to protect its investment and demand repayment in full, or taking possession of collateral or impact on the share's valuation by analyst and banks. These proposed amendments would have become effective for reporting periods beginning on or after 2023.

4. Final amendments “Non-current liabilities with covenants” to IAS 1 (2022)

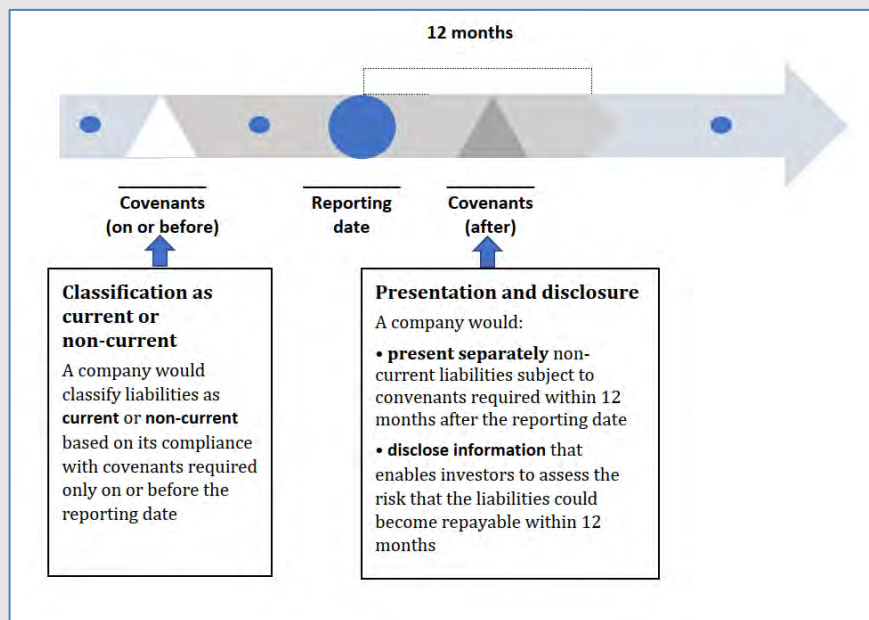
To respond to the concern raised by the stakeholders in respect to the 2020 amendments the IASB issued the final amendments in October 2022 that clarified that the covenants applied after the reporting date are not impacting the classification of a liability as current or non-current at the reporting date. The final amendments are increasing the disclosure requirements that will allow the users of financial statements to understand the risk that the liabilities could become repayable within twelve months after the reporting period, including:

- (a) information about the covenants (including the nature of the covenants and when the entity is required to comply with them) and the carrying amount of related liabilities;
- (b) facts and circumstances, if any, that indicate the entity may have difficulty complying with the covenants – for example, the entity having acted during or after the reporting period to avoid or mitigate a potential breach.

The expectation from the practice and the preparers is at today that such amendments will not impact the classification of the liabilities compared to the current guidance however the required disclosure will increase.

The new amendments will be effective for annual reporting periods beginning on or after 1 January 2024.

Table 2 – Final IAS 1 amendment (2022)



5. Concluding remarks

The first proposal of amendments of IAS 1 issued in 2020 would have been caused significant effects due to the reclassification of many financial liabilities from non-current to current with the result of breaching covenants even if at the reporting date such financial covenants were complied.

In the current context environment with higher interest rates, when companies often face challenges in accessing credit or repaying existing loans due to reduced liquidity and increased financial risk. these reclassifications would have generated have impacts on the companies such as loss of lender confidence, increased borrowing costs, restricted access to credit and negative impact on stakeholders.

Following the concerns raised by the stakeholders the final amendments “Non-current liabilities with covenants” to IAS 1 issued in October 2022 have focused more to the disclosure avoiding the risk of increased reclassification and negative impact on the companies.

It is important for companies to closely monitor their financial covenants, especially during periods of financial crisis, and take proactive measures to address any potential breaches. Engaging in open communication with lenders and increased disclosure as required by the new amendments to IAS 1 can help mitigate the risk of impact of breaching financial covenants and increase the chances of financial recovery.

References

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