



Classification of liabilities: Loan covenants

During 2020, the IASB issued amendments to IAS 1 relating to the classification of liabilities. These amendments primarily dealt with the effect of debt covenants on the classification of liabilities. Following concerns by stakeholders, further amendments to these requirements were issued in October 2022. This article considers the 2022 amendments.

Financial statements distinguish between current and non-current assets and liabilities. Assets are classified on, amongst others, the expectations of the entity. The classification of liabilities, however, depends on the business model and terms of the instruments.

The IASB published an amendment to IAS 1 titled *Non-current Liabilities with Covenants* at the end of 2022. This article discusses the background to this and the amendments.

Background

During 2020, the IASB issued amendments to IAS 1 regarding the classification of liabilities as current or non-current. The effective date for the amendments was postponed to reporting periods beginning on or after 1 January 2023 to provide preparers with sufficient time to apply the amendments following the added pressure created by the covid-19 pandemic. The amendments required liabilities with debt covenants attached to them to be classified as if the reporting date was the covenant measurement date, even if it was not actually the case. I considered those amendments in an earlier article.

Stakeholders raised concerns about the effect of these amendments. This included that they did not consider that parties align loan covenants dates with the entity's business seasonality or cycles. Also, applying the revised rules to covenants tested over a period of time remained unclear. As a result, they questioned the usefulness of the information presented. The 2022 amendments aim to address the concerns around the 2020 amendments.

2022 amendments

The classification requirement primarily affected by the 2020 amendments remains unchanged. It states that:

'An entity shall classify a liability as current when: ...

(d) it 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.'

The related guidance, however, changes. The 2022 amendment state that where an entity's right to defer settlement of a liability that arises from a loan is subject to compliance with conditions (covenants), the effect will be:

- If the covenants affect whether the right to defer exists at the end of the reporting period (i.e. the entity must have complied with them at or before the reporting date), compliance with the covenants must be taken into account to classify the liability.
- If the covenants do not affect the right to defer at the reporting date (i.e. the entity must only comply with it at a future date), the covenant does not affect the classification at the reporting date. In this case, the entity should disclose information in the notes that assist users to understand the risk of the liability becoming payable within 12 months from the reporting date.

Effective date

Both sets of amendments apply for periods beginning on or after 1 January 2024. Practically, the transitional provisions require that an entity must simultaneously apply both sets of amendments.

