IFRS Quarterly Navigator:

Your Financial Reporting Roadmap

Quarter 4 2023

Introduction

IFRS News is your quarterly update on issues relating to IFRS Accounting Standards. We'll bring you up to speed on topical issues and all recent developments, provide comments and give our perspective on relevant topics.

We are pleased to welcome you to this IFRS-related news edition by Grant Thornton Greece, your quarterly update on issues related to IFRS Accounting Standards.

The main objective of this edition is to keep you informed about the recent news and advancements in the field of IFRS Accounting Standards.

Our aim is to provide you with relevant support, useful information, and an understanding of the potential impact these developments may have on your business, by bringing to you the most relevant and up-to-date information and keeping you at the forefront of the ever-evolving world of financial reporting.

From significant standard updates and IASB proposed amendments to thought-provoking articles, our team of experts has crafted this edition to address your informational needs. This edition includes:

- Latest IFRS updates
- Latest IASB proposed amendments
- Technical insights from our experts
    - Top 10 issues for financial reporting preparers and how to avoid them (FRC's Annual Review of Corporate Reporting 2022/2023 published in October 2023)
    - Non-current Liabilities with Covenants
- Grant Thornton International's Thought Leadership
    - IFRS Example Consolidated Financial Statements 2023
    - Insights into IFRS 3
    - Insights into IFRS 2

We also invite you to actively engage with us by sharing your thoughts, questions, or suggestions. Your input is invaluable in shaping the content of future editions.

We hope that you find our IFRS Quarterly Navigator edition enlightening and a valuable resource for your professional journey, and should you wish to discuss any of the topics covered, please feel free to contact us.

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01 Latest IFRS updates

This section presents IASB new amendments which have been published in the period from September 2023 until December 2023.

Latest IFRS updates

December 2023 Hyperinflation update

Executive summary

According to the World Economic Outlook (WEO) report issued by the International Monetary Fund (IMF) in October 2023, and based on economic conditions that currently exist in Ghana, Sierra Leone and Haiti, these countries are now considered to be hyperinflationary from 31st December 2023. Therefore, reporting entities in those countries will be required to apply IAS 29 'Financial Reporting in Hyperinflationary Economies'. Consequently, any entities with interim or annual financial reporting requirements at 31 December 2023 or thereafter should reflect IAS 29 in their IFRS financial statements.

The WEO report also identifies that South Sudan might no longer be in a hyperinflationary economy from 31 December 2023.

From 31st December 2023 onwards, there are thirteen countries around the world where IAS 29 should be applied, when entities want to state they are in full compliance with IFRS. These countries are: Argentina, Ethiopia, Ghana, Haiti, Iran, Lebanon, Sierra Leone, Sudan, Suriname, Turkey, Venezuela, Yemen (which should be closely monitored) and Zimbabwe.

Recapping the requirements of IAS 29

IAS 29 lists factors that indicate when an economy is hyperinflationary. One of the indicators of hyperinflation is if cumulative inflation over a three-year period approaches, or is in excess of 100 per cent.

The mechanics of restatement

IAS 29 requires amounts in the statement of financial position that are not already expressed in terms of the measuring unit current at the end of the reporting period, are restated by applying a general price index. In summary:

- assets and liabilities linked by agreement to changes in prices, such as index linked bonds and loans, are adjusted in accordance with the agreement
- non-monetary items carried at current amounts at the end of the reporting period (such as net realisable value and fair value) are not restated
- all other non-monetary assets and liabilities are restated
- monetary items (i.e. money held and items to be received or paid in money) are not restated because they are already expressed in terms of the monetary unit currency at the end of the reporting period and
- all items in the statement of comprehensive income should be expressed using the measuring unit current at the end of the reporting period, so all amounts need to be restated from the dates when the items of income and expenditure were originally recorded in the financial statements.

December 2023 Hyperinflation update

Other important factors that should be taken into consideration when applying IAS 29

IAS 29 sets out specific requirements on how to restate prior period comparatives. It requires corresponding figures for the previous reporting period to be restated by applying a general price index so that the comparative financial statements are presented in terms of the measuring unit current at the end of the reporting period.

IAS 29 may result in the creation of additional temporary differences under IAS 12 'Income Taxes'. This is because the restatement of items under IAS 29 will often lead to adjustments to the carrying amounts of items without corresponding changes to their tax bases. Be mindful that IAS 12 requires these adjustments to be recognised in profit or loss.

Impairment testing should also not be overlooked. IAS 29 requires any restated non-monetary items to be reduced when it exceeds its recoverable amount, even if those assets were not previously considered impaired under historical cost accounting. It will be important when preparing financial statements to consider whether the restatement of asset carrying values affects the results of impairment tests that were conducted in previous reporting periods, and whether there are any indicators of impairment for assets that were not tested for impairment in previous periods.

IFRIC decisions relating to hyperinflation

The IFRS Interpretations Committee (IFRIC) have previously considered a number of accounting issues in relation to dealing with hyperinflation. These include:

- translating a hyperinflationary foreign operation and presenting exchange differences
- accounting for cumulative exchange differences before a foreign operation becomes hyperinflationary
- presenting comparative amounts when a foreign operation first comes hyperinflationary and
- consolidation of a non-hyperinflationary subsidiary by a hyperinflationary parent.

We encourage careful consideration of these issues when preparing IFRS financial statements and applying IAS 29.

Our thoughts

IAS 29 is not a Standard that can be quickly implemented, particularly in group situations. Careful consideration needs to be given to the IFRIC guidance dealing with situations where there is a hyperinflationary parent that has subsidiaries who also report in a hyperinflationary currency versus situations where a non-hyperinflationary parent has subsidiaries that report in a hyperinflationary currency. Also, be mindful of how a hyperinflationary parent with subsidiaries that do not report in a hyperinflationary currency should be accounted for given the requirements set out in IAS 21 "The Effects of Changes in Foreign Exchange Rates".

Any reporting entity considering IAS 29 for the first time will have to adapt their existing accounting systems to be able to process the hyperinflationary adjustments. It is important they understand the mechanics of adjusting for hyperinflation so they can restate in their financial statements both current and comparative periods.

International tax reform - Pillar Two Model Rules (Amendments to IFRS for SMEs)

Executive Summary

The International Accounting Standards Board (IASB) has amended the IFRS for SMEs. The amendments, entitled 'International Tax Reform—Pillar Two Model (Amendments to the IFRS for SMEs)' are based on the amendments to IAS 12 'Income Taxes' issued in May 2023, and address the impacts of the introduction of the Organisation for Economic Co-operation and Development's (OECD) Pillar Two Model Rules. The amendments introduce a temporary exception and targeted disclosure requirements.

Background

The OECD published its Pillar Two Model Rules in December 2021 to ensure that large multinational companies (ie groups with revenue of EUR750 million or more in two of the last four years) would be subject to a minimum 15% tax rate. The reform is expected to apply in most jurisdictions for accounting periods starting on or after 1 January 2024.

However, while the reaction from jurisdictions around the world to implement the changes has been positive, there have been major stakeholder concerns about the uncertainty over the accounting for deferred taxes arising from the implementation of these rules. Those concerns mainly refer to identifying and measuring deferred taxes, because determining whether the Pillar Two Model Rules will create additional temporary differences is very difficult and also which tax rate will be applicable (considering the number of factors affecting its determination).

Following similar amendments to IAS 12 'Income Taxes', issued in May 2023, the IASB has issued these 'out-of-cycle' amendments to the IFRS for SMEs to provide direction on what they expect entities to disclose.

The Amendments

- Introduce a temporary recognition exception for entities applying the IFRS for SMEs from recognising deferred tax assets and liabilities arising from Pillar Two Model Rules, and from the related disclosures on deferred tax assets and liabilities that would otherwise be required.
- Provide clarification on the disclosures required by entities applying the IFRS for SMEs. This includes disclosing the current tax expense/income arising from Pillar Two Model Rules, and a statement that it has applied the exemption from recognising deferred tax balances relating to Pillar Two Model Rules.

Effective Date

Entities can benefit from this temporary exception immediately and are required to provide the disclosures set out in the amendments for reporting periods beginning on or after 1 January 2023.

Our thoughts

As with the previous amendments to IAS 12, we welcome these amendments because many of our clients around the world have indicated they are concerned at the amount of time, cost and effort that will be required to assess the accounting implications associated with the tax consequences arising from the implementation of the Pillar Two Model Rules.

Similarly, we commend the IASB for moving quickly to extend the guidance and relief to entities who report under the IFRS for SMEs, as they too face uncertainty due to the Pillar Two Model Rules.

02 Technical Insights

In this section of our IFRS Quarterly Navigator edition, we bring you technical insights and viewpoints from experts in the field of financial reporting. We encourage you to dive into these articles and join us on this intellectual journey as we explore the frontiers of financial reporting and unlock new insights that will empower you to navigate the complexities of IFRS Accounting Standards.

Technical Insights

Top 10 issues for financial reporting preparers and how to avoid them

(based on FRC's Annual Review of Corporate Reporting 2022/2023 published in October 2023)

Companies around the world have faced several years of economic and geopolitical turbulence following the pandemic and Russia's invasion of Ukraine. Interest rate rises in response to persistent inflation, the related impact on consumer behaviour, and limited growth remain immediate concerns in many economies. There are also considerable uncertainties surrounding companies' exposures to climate change and their plans for the transition to a low carbon economy.

This presents a challenging environment for financial reporting as companies need to consider, and communicate to investors, how these issues affect their business, as well as the assumptions underpinning the values of assets and liabilities in their financial statements.

Each year the FRC publishes an Annual Review of Corporate Reporting, which describes the activity and findings of its Corporate Reporting Review function for the 12-months to 31 March. Along with the associated material its aim is to help companies improve their corporate reporting by highlighting key improvement areas and matters on which companies should focus in the coming year. In its annual report, **FRC outlined the more significant or common issues that arose as a result of its reviews**. These summaries are not a substitute for knowing the relevant reporting requirements, but they do provide insights into common areas for improvement.

In the next pages we present the relevant findings on financial reporting issues at a glance.

You may find full FRC's report here.

We encourage preparers to review this report and assess its relevance to their own reports and accounts. We believe that this report can serve as a valuable resource to help avoid regulatory challenges.

You can access the article here.

Technical Insights

Non-current liabilities with covenants

What's the issue?

Loan agreements often include covenants that, if breached by the borrower, permit the lender to demand repayment before the loan's normal maturity date. In response to a borrower's request, lenders may decide to voluntarily waive some or all of the rights they acquire as a result of a breach.

This article provides guidance on the classification of long-term loans payable as either current or non-current when covenants are present. It has been extracted from GTI's IFRS Viewpoint "Classification of loans with covenants", the full version of which

You may find here.

We also present 2022 amendments to IAS 1 "Non-Current Liabilities with Covenants" for annual periods beginning on or after 1st January 2024.

You may find here.

Overview

Classification of a long-term loan payable as either a current or non-current liability is **based on the existing rights of the borrower and lender (the 'condition of the loan') at the reporting date:**

- when a borrower has the right to defer settlement for at least 12 months beyond the reporting date, a loan is classified as non-current.
- the anticipated outcome of future covenant tests (based on financial conditions existing after the end of the current reporting period) does not influence the classification of a loan at the reporting date.
- when assessing the impact of waivers, it is important to consider both the timing of the waiver and how it affects the rights of the parties at the reporting date.

More detailed comments below assume that a breach of a borrowing covenant entitles the lender to require repayment on demand.

Additionally, we present IAS 1 amendments "Non-Current Liabilities with Covenants" which issued in October 2022 in order to improve the information an entity provides about liabilities arising from loan arrangements for which an entity's right to defer settlement of those liabilities is subject to compliance with covenants within twelve months after the reporting period. The 2022 amendments introduce additional disclosures requirements that enable users of financial statements to understand the risk that non-current liabilities with covenants could become repayable within twelve months of the reporting period. These amendments are effective for annual reporting period beginning on or after 1st January 2024.

03 IASB proposed amendments

This section presents IASB proposed amendments for which exposure drafts have been published in period from September 2023 until December 2023.

IASB proposed amendments

Exposure Draft: Financial Instruments with Characteristics of Equity

Introduction

The International Accounting Standards Board (IASB) published the "Financial Instruments with Characteristics of Equity (Discussion Paper)" in June 2018 to respond to the challenges stakeholders identified in classifying financial instruments in accordance with IAS 32. The Discussion Paper proposed a new classification approach to articulate more clearly the principles for classifying financial instruments as financial liabilities or equity instruments, and to improve the consistency, completeness and clarity of the classification requirements in IAS 32. After considering feedback on the Discussion Paper, the IASB decided not to pursue the proposed classification approach. Instead, the IASB decided to focus on clarifying the classification requirements in IAS 32, including their underlying principles, to address known practice issues that arise in applying IAS 32.

In November 2023, the International Accounting Standards Board (IASB) published the 'Exposure Draft Financial Instruments with Characteristics of Equity'.

The IASB aims:

a) to improve the information a company provides in its financial statements about its financial liabilities and equity instruments within the scope of IAS 32 "Financial Instruments: Presentation" and

b) to resolve application issues companies, have when applying the classification requirements in IAS 32.

Proposed Amendments

The proposals in the Exposure Draft would amend IAS 32 "Financial Instruments: Presentation", IFRS 7 "Financial Instruments: Disclosures", and IAS 1 "Presentation of Financial Statements".

The IASB proposes amendments:

- to clarify the requirements and underlying principles in IAS 32 for classifying financial instruments.
- to amend IFRS 7 "Financial Instruments: Disclosures" to require disclosures about financial liabilities and equity instruments within the scope of IAS 32 and
- to amend IAS 1 "Presentation of Financial Statements" to require separate presentation of amounts attributable to ordinary shareholders.

The Exposure Draft is open for comment until 29 March 2024.

04 Grant Thornton International Ltd’s Thought Leadership

Grant Thornton International Ltd has released: (a) the 2023 version of “IFRS Example Consolidated Financial Statements 2023”, (b) three articles in series on Insights to IFRS 3 “Business Combinations” and c) two articles in series on Insights to IFRS 2 "Share-based Payment".

IFRS Example Consolidated Financial Statements 2023

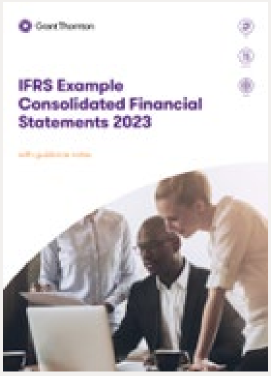
Grant Thornton International have published the 2023 version of 'IFRS Example Consolidated Financial Statements 2023' ('Example Financial Statements').

The publication has been reviewed and updated to reflect changes in IFRS that are effective for the year ending 31 December 2023.

In particular, this year our example financial statements include some illustrative guidance on climate-related financial disclosures to help entities when assessing the impact of climate on their financial statements and some things for entities to consider in times of economic uncertainty.

Our objective is to illustrate one possible approach to reporting by an entity engaging in transactions that are 'typical' across a range of non-specialist sectors. However, as with any example, this illustration does not envisage every possible transaction and therefore cannot be regarded as comprehensive. Other approaches may be more appropriate in specific circumstances.

You can access the publication at [IFRS Example Consolidated Financial Statements 2023 | Grant Thornton insights]



Insights into IFRS 3 "Business Combinations"

Insights into IFRS 3

The next three articles in GTI's series on Insights into IFRS 3 'Business Combinations' have been released.

Mergers and acquisitions (business combinations) can have a fundamental impact on the acquirer's operations, resources and strategies. For most entities such transactionsare infrequent, and each is unique. IFRS 3 'Business Combinations' contains the requirements for these transactions, which can be challenging in practice. The Standard itself has now been in place for more than ten years and has undergone a comprehensive post implementation review by the International Accounting Standards Board (IASB).

'Insights into IFRS 3' series summarizes the key areas of the Standard, highlighting aspects that are challenging to interpret and apply in practice. The articles included in this release present guidance on IFRS 3's requirements for recognizing and measuring non-controlling interests (NCI), determining and measuring the amount of consideration transferred, and determining what is part of a business combination in cases where there are other transactions and arrangements between parties. They are as follows:

Insights into IFRS 3 - Recognising and measuring non-controlling interests

This article sets out the requirements for recognising and measuring any non-controlling interest (NCI).

You can access the publication at

IFRS 3 - Recognising and measuring non-controlling interests | Grant Thornton insights


Insights into IFRS 3

Insights into IFRS 3 - Consideration transferred

This article discusses the main practical issues affecting consideration transferred, using examples to illustrate some of the requirements. Download the full pdf for example illustrations.

You can access the publication at

IFRS 3 - Consideration transferred | Grant Thornton insights


Insights into IFRS 3

Insights into IFRS 3 "Business Combinations"

Insights into IFRS 3 - Determining what is part of a business combination transaction

Only consideration transferred in exchange for the acquiree is considered in the calculation of goodwill (or gain on a bargain purchase). Payments that, in substance, relate to separate transactions are not included in consideration transferred for the business combination transaction and may give rise to a separate gain, loss, liability or asset. This article discusses such transactions.

You can access the publication at [IFRS 3 - Determining a business combination transaction | Grant Thornton insights]

Insights into IFRS 2 "Share-based Payment"

Insights into IFRS 2

IFRS 2 was introduced in 2004 and the accounting principles have remained largely unchanged since. Share-based payments have become increasingly popular over the years, with many entities using equity instruments or cash and other assets based on the value of equity instruments as a form of payment to directors, senior management, employees and other suppliers of goods and services.

The accounting of share-based payments is an area that remains not well understood and this is evidenced by a number of Interpretations and agenda decisions being issued by the IFRS Interpretations Committee (IFRIC).

Considerable care needs to be applied in evaluating the requirements set out in IFRS 2 and other authoritative guidance to increasingly complex and innovative share-based payment arrangements.

GTI's 'Insights into IFRS 2' series is aimed at demystifying the Standard by explaining the fundamentals of accounting for share-based payments using relatively simple language and providing insights to help entities cut through some of the complexities associated with accounting for these types of arrangements.

The first two articles are as follows:

Insights into IFRS 2 – What is IFRS 2?

This article provides an overview including the objective and scope of IFRS 2.

You can access the publication here.


Insights into IFRS 2

Insights into IFRS 2 – Classification of share-based payment transactions and vesting conditions

This article focuses on share-based payments directly between the reporting entity and a counterparty.

You can access the publication at here.


Insights into IFRS 2

Appendixes

Top 10 issues for financial reporting prepares and how to avoid them.

(based on FRC's Annual Review of Corporate Reporting 2022/2023 published in October 2023)

Companies around the world have faced several years of economic and geopolitical turbulence following the pandemic and Russia's invasion of Ukraine. Interest rate rises in response to persistent inflation, the related impact on consumer behaviour, and limited growth remain immediate concerns in many economies. There are also considerable uncertainties surrounding companies' exposures to climate change and their plans for the transition to a low carbon economy.

This presents a challenging environment for financial reporting as companies need to consider, and communicate to investors, how these issues affect their business, as well as the assumptions underpinning the values of assets and liabilities in their financial statements.

Each year the FRC publishes an Annual Review of Corporate Reporting, which describes the activity and findings of its Corporate Reporting Review function for the 12-months to 31 March.

Along with the associated material its aim is to help companies improve their corporate reporting by highlighting key improvement areas and matters on which companies should focus in the coming year. In its annual report, **FRC outlined the more significant or common issues that arose as a result of its reviews.** These summaries are not a substitute for knowing the relevant reporting requirements, but they do provide insights into common areas for improvement.

You may find FRC's report here.

We encourage preparers to review this report and assess its relevance to their own reports and accounts. We believe that this report can serve as a valuable resource to help avoid regulatory challenges.

Issue 1: Impairment of Assets

Companies should ensure that

- **key inputs and assumptions applied in impairment testing have been disclosed and explained,** including the relevant values and sensitivity analysis, were required. Additional disclosures are required where headroom is low, and heightened uncertainties over inflation, consumer demand and interest rates may drive a wider range of reasonable possible outcomes for future cashflows and discount rates. Users should be able to understand how assumptions are consistent with discussion of uncertainties elsewhere in the report.
- **Impairment testing methodology complies with IFRS**, particularly that the grouping of assets into Cash Generating Units (CGUs) is appropriate, the treatment of inflation in the discount rate and cash flows is consistent; and cashflows in "value in use" calculations reflect the current condition of assets, before ant future enhancement expenditure.

Top 10 issues for financial reporting prepares and how to avoid them.

Issue 2: Judgements and Estimates

Companies should ensure that

- **all significant judgements, including those applied in performing going concern assessment, have been described.** It is not sufficient to list the matters requiring judgment.
- **disclosures about estimates include values, sensitivities and explain significant changes.** Sources of estimation uncertainty with a significant risk of resulting in a material adjustment within one year should be clearly distinguished from other estimates.
- **disclosures are reassessed every year** to confirm all relevant matters are captured, immaterial issues are not rolled forward and the assumptions and ranges of reasonable possible outcomes remain appropriate in the company's current circumstances.

Issue 3: Cash flow statements

Companies should ensure that

- **a robust pre-issuance review has been performed.** It is common to find "routine errors" from basic consistency checks, comparing the cash flow statement to other information in the financial statements. Other common errors relate to classification, netting and reporting non-cash movements in the cash flow statement.

Issue 4: BoD report and other Companies Act matters

Companies should ensure that

- **the strategic report provides a fair, balanced and comprehensive review** of the company's development, position, performance and future prospects. This should include unbiased discussion of positive and negative aspects of performance, a clear articulation of the effects of economic uncertainty on the business, and should address significant movements in the financial statements, including those in the cash flow and balance sheet.
- **all statutory requirements have been met.**

Issue 5: Financial instruments

Companies should ensure that

- **material risks arising from financial instruments are adequately disclosed,** along with how these are managed. In particular, this included risks driven by inflation and rising interest rates, and related hedging arrangements.
- **information about banking covenant is provided** unless the likelihood of any breach information in considered remote.

Issue 6: Income Taxes

Companies should ensure that

- **forward-looking assessments to support the recovery of deferred tax assets are based on appropriate assumptions** about the future taxable profits. Where companies have been loss-making, the nature of the convincing evidence supporting recognition of the assets must be disclosed.
- **Tax related disclosures throughout the report and accounts are consistent,** and material reconciling items in the effective tax rate reconciliation are adequately explained.

Top 10 issues for financial reporting prepares and how to avoid them.

Issue 7: Revenue

Companies should ensure that

- **accounting policies are provided for all significant revenue streams** and describe the methodology applied, including the timing of revenue recognition, the basis of recognizing any revenue over time, and any significant judgements made in applying those policies.
- **they describe inflationary features in customer contracts** and the corresponding accounting treatment.

Issue 8: Provisions and contingencies

Companies should ensure that

- **they provide clear and specific descriptions of the relevant exposure,** including the basis for determining the best estimate of the relevant outflow, and the timeframe over which it is expected to crystallize.
- **the calculation and presentation comply with IFRS.** Provisions should not be presented net of any reimbursement assets and a consistent approach should be taken in reflecting the effects of inflation in cash flows and discount rates.

Issue 9: Presentation of financial statements and related disclosures

Companies should ensure that

- **company specific information about material accounting policies and transactions** is disclosed. It is important that these explain how the policies apply to the company's particular circumstances.
- **the financial statements are carefully reviewed.** Common issues found include errors in the classification of intercompany receivables balances between current and non-current, and failure to disclose material impairments of receivables on the face of the income statement.

Issue 10: Fair value measurement

Companies should ensure that

- **fair value measurements use market participants' assumptions, and provide high quality disclosures.** Most issues found in the disclosure of recurring Level 3 measurements, for which the significant unobservable inputs should be quantified and a sensitivity analysis given. **Companies should consider the need for specialist third party advice** where no internal expertise exists.

Non-current liabilities with covenants

What's the issue?

Loan agreements often include covenants that, if breached by the borrower, permit the lender to demand repayment before the loan's normal maturity date. In response to a borrower's request, lenders may decide to voluntarily waive some or all of the rights they acquire as a result of a breach.

This article provides guidance on the classification of long-term loans payable as either current or non-current when covenants are present.

It has been extracted from GTI's IFRS Viewpoint "Classification of loans with covenants", the full version of which you may find in the following link

We also present 2022 amendments to IAS 1 "Non-current Liabilities with Covenants" for annual reporting periods beginning on or after 1st January 2024.

A. Classification of loans with covenants

Overview

According to IAS 1 para 74 "*When an entity breaches a provision 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 an unconditional right to defer its settlement for at least twelve months after that date.". Additionally, para 75 of IAS 1 states that "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."*

Classification of a long-term loan payable as either a current or non-current liability is based **on the existing rights of the borrower and lender (the 'condition of the loan') at the reporting date:**

- when a borrower has the right to defer settlement for at least 12 months beyond the reporting date, a loan is classified as non-current.
- the anticipated outcome of future covenant tests (based on financial conditions existing after the end of the current reporting period) does not influence the classification of a loan at the reporting date.
- when assessing the impact of waivers, it is important to consider both the timing of the waiver and how it affects the rights of the parties at the reporting date.

More detailed comments below assume that a breach of a borrowing covenant entitles the lender to require repayment on demand.

Non-current liabilities with covenants

Effect of a covenant breach on classification

Loan covenants can take many forms. A typical example requires a borrower to maintain one or more key financial ratios (such as interest cover or a debt-to-equity ratio) above or below a specified benchmark. When a borrower **breaches a covenant on or before the reporting date, the loan should be classified as current if the borrower does not have the right to defer settlement for at least 12 months after the reporting date.**

The assessment of whether a long-term loan should be classified as current or non-current is based on the condition of the loan at the reporting date. This means that:

- if a company breaches a covenant before the end of the reporting period and as a result does not have the right to defer payment for a period of at least 12 months following the reporting date, the loan is classified as current.
- if a company breaches a covenant after the end of its reporting period but before the date of approval of its financial statements, the loan continues to be classified as noncurrent. This is an example of a non-adjusting event (see IAS 10) that must be disclosed in the financial statements.
- when information comes to light after the end of a reporting period indicating that covenants have, in fact, been breached at period end (due to effects of adjusting events), this is an example of an adjusting event and the loan is classified as current.
- the anticipated outcome of future covenant tests (based on financial conditions existing after the end of the current reporting period) does not influence the classification of a loan at the reporting date. This is true even when the borrower believes it is likely that it will 'fail' the future tests.
- whether or not a breach has been reported to the lender is irrelevant.

Covenant waivers

A lender may choose to waive the right to demand repayment it acquires as a result of a borrower's covenant breach. For example, a waiver may:

- unconditionally 'forgive' the past breach so that the lender no longer has (and never will have) a right to demand repayment as a result of that breach.
- document the lender's agreement not to demand repayment for a fixed period of time after which it will decide whether to require settlement.
- be conditional on the borrower satisfying new or additional covenants or tests specified by the lender.

When assessing the impact of waivers on the related loan's classification, it is important to consider both the timing of the waiver and how it affects the rights of the parties at the reporting date.

Timing

A waiver can only result in a loan being classified as non-current if it is obtained on or before the reporting date.

If a lender provides a waiver after the reporting date, the borrower classifies the liability as current because at the reporting date it did not have the right to defer settlement for at least the next 12 months. The grant of the waiver is disclosed as a non-adjusting event if obtained before the date of approval of the financial statements.

Non-current liabilities with covenants

Effect on rights of parties

When an entity breaches a provision condition 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 authorization 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 an unconditional the right to defer its settlement for at least twelve months after that date.

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.

Uncertainty as to whether a covenant has been breached

The terms of loan covenants are sometimes expressed qualitatively, or in some other way that requires interpretation or judgement. For example, a covenant may refer to ‘a material adverse change in the circumstances of the borrower’.

Determining whether or not a breach has occurred at the reporting date may then require clarification from the lender or legal advice. However, the mere existence of such a covenant does not automatically lead to the loan being classified as current. The borrower may still have the right to defer settlement for at least 12 months after the reporting period.

In some cases, the language used to describe a covenant suggests the lender has absolute discretion in deciding whether a breach has occurred. Such covenants are similar in substance to a demand feature and the related loans should be reported as current liabilities.

This view was confirmed by the IFRIC in September 2010 in a so-called ‘agenda decision’. The IFRIC considered term loan arrangements with features allowing lenders to call the loan at any time and for any reason. The question asked was how such terms would impact a company’s classification of the loan as either current or non-current under IAS 1.

The IFRIC’s view was that classification of the loan as current or non-current should be determined based on the rights and obligations of the lender and the borrower on the relevant date. When a condition allows the lender to demand repayment at any time in its sole discretion, the borrower does not have the right to defer settlement for at least 12 months.

Disclosure

When a breach occurs during the period and the breach is not remedied nor the loan renegotiated before the reporting date, IFRS 7 requires the following disclosures (where the information is considered to be material to the financial statements):

- details of the breach
- the carrying amount of the related loan
- whether the breach was remedied or the terms of the loan renegotiated before the financial statements were authorised for issue.

When the breach occurs after the reporting date but before the financial statements are authorized for issue, this is a non-adjusting event and the loan will continue to be classified as non-current. Details of the breach will need to be disclosed together with an estimate of its financial effect, or a statement that such an estimate cannot be made.

Non-current liabilities with covenants

Covenant breaches – the bigger picture

The breach of a loan covenant may indicate the existence of wider problems with a borrower's overall financial health. While all breaches may cause concern, when a breach remains unremedied and the lender has obtained a right to demand accelerated repayment of the related loan, this may impact a borrower's ability to continue as a going concern.

A borrower considers the impact of covenant breaches and other relevant factors and assesses whether there are material uncertainties over its ability to continue as a going concern. Even though a breach (or other relevant event) may not occur until after the reporting date, it must still be considered. If material uncertainties are found to exist, they must be disclosed.

Occasionally, the impact of a covenant breach is so severe that the going concern assumption is no longer appropriate and management has little choice but to liquidate or cease operations. When this happens, a company is required to prepare its financial statements on a basis other than going concern. Selecting an appropriate basis will require the exercise of professional judgement and the basis selected will need to be disclosed.

Practice Tip – Timing is everything!

You are the CFO of a company with a calendar year-end and a long-term bank loan with financial covenants. As with many such loans, the bank requires you to assess the covenants at the end of each quarter, and to report to the bank within the following 30 days. If the covenants are breached, the loan is repayable immediately.

In this very common situation, companies face a challenge. By the time you complete your end of year assessment of covenant compliance, it might be too late to obtain a pre-year end waiver (assuming one is needed) as the waiver must be received before period end!

So what can you do to avoid showing the loan as a current liability in your year-end financial statements?

1. Timing is everything – monitor your covenants closely throughout the year. If early December arrives and you think there is a possibility that covenants may be breached at year-end, start speaking with your banker immediately to maximise the chances of obtaining a waiver pre-year end if necessary;

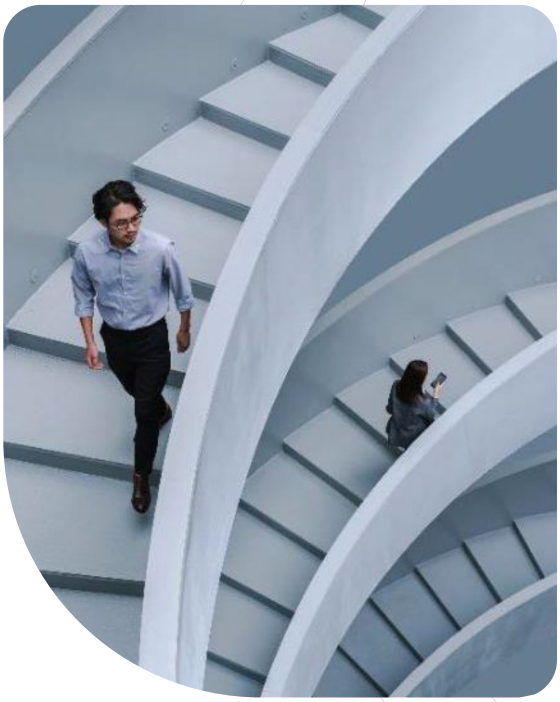
2. Plan ahead – when negotiating long-term loans, see if your bank is willing to consider off-quarter covenant testing (e.g. 28 February, 31 May, 31 August, and 30 November).

Non-current liabilities with covenants

B. Amendments to IAS 1: Non-current Liabilities with Covenants

Executive summary

In October 2022, the IASB issued 'Non-current Liabilities with Covenants' (hereinafter "the 2022 amendments") which amended IAS 1 'Presentation of Financial Statements'. The 2022 amendments to improve the information an entity provides about liabilities arising from loan arrangements for which an entity's right to defer settlement of those liabilities is subject to compliance with covenants within twelve months after the reporting period, in addition to addressing stakeholders' concerns about how a company classifies those liabilities as current or non-current. The amendments clarify that only covenants with which an entity is required to comply on or before the reporting will affect classification of a liability as current or non-current at the reporting date. The 2022 amendments introduce additional disclosures requirements that enable users of financial statements to understand the risk that non-current liabilities with covenants could become repayable within twelve months of the reporting period.



Background

The 2022 amendments were in response to concerns raised on applying previous amendments to the "Classification of liabilities as current or non-current" issued in 2020 (hereinafter "2020 amendments") that would have become effective for reporting periods beginning on or after 2023. In particular, stakeholders said that the 2020 amendments:

i. could result in an entity classifying a liability as current even if, at the end of the reporting period (reporting date), the entity has no contractual obligation to settle the liability at that date or within twelve months.

ii. took no account of the design of covenants negotiated to reflect an entity's required financial position or performance at specified dates, such as when a loan arrangement specifies different covenants at different dates to reflect the expected effects of seasonality or the entity's future performance and

iii. were unclear about how an entity would assess, at the reporting date, whether it would have complied with covenants that are not based on an entity's financial position or performance (non-financial covenants) and covenants based on cumulative financial performance or cash flows for a period extending beyond the reporting period (financial performance covenants).

The IASB made the 2022 amendments to improve the information an entity provides about liabilities arising from loan arrangements for which an entity's right to defer settlement of those liabilities for at least twelve months after the reporting period is subject to the entity complying with conditions specified in the loan arrangement (liabilities with covenants).

Non-current liabilities with covenants

Amendments

The 2020 amendments

Two of the 2020 amendments that were not impacted by the 2022 amendments are presented below.

The Board added paragraph 75A, which explicitly clarifies that classification is unaffected by management intentions or expectations, or by settlement of the liability within twelve months after the reporting period. Therefore, a liability is classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period or even if the entity settles the liability between the end of the reporting period and the date the financial statements are authorised for issue. However, in either of those circumstances, 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.

The Board also added paragraphs 76A and 76B to IAS 1 to clarify the meaning of 'settlement' of a liability. In paragraph 76A is stated that: "For the purpose of classifying a liability as current or non-current, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of:

(a) cash or other economic resources—for example, goods or services, or

(b) the entity's own equity instruments, unless paragraph 76B applies."

Based on the paragraph 76A, the transfer of own equity instruments is considered settlement for the purpose of classification of liabilities as current or non-current, with one exception which is stated in paragraph 76B:

"Terms of a liability that could, at the option of the counterparty, result in its settlement by the transfer of the entity's own equity instruments do not affect its classification as current or non-current if, applying IAS 32 Financial Instruments: Presentation, the entity classifies the option as an equity instrument, recognizing it separately from the liability as an equity component of a compound financial instrument." Therefore, if a counterparty has the option to require settlement in equity of the reporting entity of a liability within twelve months, the liability would be classified as current unless the entity classifies the option as an equity component of a compound financial instrument.

Non-current liabilities with covenants

Amendments

The 2022 amendments

Under the 2022 amendments, only covenants that an entity is required to comply with on or before the reporting date affect classification of a liability as current or non-current, even if compliance with such covenants is assessed only after the reporting period (for example, a covenant based on the entity's financial position at the end of the reporting period but assessed for compliance only after the reporting period). Covenants of loan arrangements which an entity is required to comply with after the reporting period (for example, a covenant based on the entity's financial position six months after the end of the reporting period) does not affect the classification of a liability as current or non-current at the reporting date.

The 2022 amendments also introduce additional disclosure requirements when a liability arising from a loan arrangement is classified as non-current and the entity's right to defer settlement is contingent on compliance with future covenants within twelve months. IASB decided to require an entity to disclose information in the notes that enables users of financial statements to understand the risk that non-current liabilities with covenants could become repayable within twelve months of 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)

b) the carrying amount of the liability,

c) facts and circumstances, if any, that indicate the entity may have difficulty complying with the covenants. Such facts and circumstances could also include the fact that the entity would not have complied with the covenants if they were to be assessed for compliance based on the entity's circumstances at the end of the reporting period.

The IASB concluded that this information would be useful to users of financial statements because it would allow them to understand the nature of the covenants and the risk that a liability classified as non-current could nonetheless be repayable within twelve months.

Effective date

The 2020 amendments originally had an effective date for periods beginning on or after 1 January 2023. The 2022 amendments changed the effective date of the 2020 amendments. Therefore, an entity shall apply the amendments to IAS 1 for annual reporting periods beginning on or after 1st January 2024 retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Earlier application is permitted. However, an entity that applies the 2020 amendments early is also required to apply the 2022 amendments and vice versa. Earlier application should be disclosed.

Our Thoughts

Consequently, entities must thoroughly assess how 2020 and 2022 amendments to IAS 1 Presentation of Financial Statements will affect both current and future loan agreements. The 2022 amendments will result in additional disclosure being required for liabilities subject to covenants.

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