IAS 1: Application of paragraph 72A to classify a term loan as current or non-current

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IAS 1 *Presentation of Financial Statements* contains guidance regarding the classification of liabilities as either current or non-current in an entity's financial statements. In January 2020, the International Accounting Standards Board (IASB) issued amendments to IAS 1 to clarify the criterion for classifying a liability as non-current relating to the right to defer settlement of the liability for at least 12 months after the reporting period. These amendments are effective for annual reporting periods beginning on or after January 1, 2023.

The amendments introduce changes to several paragraphs in IAS 1, including amending paragraph 69(d) and adding paragraph 72A (see changes below):

69 An entity shall classify a liability as current when:

(a) it does not have ~~an unconditional~~ the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period ~~(see paragraph 73). 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~~.

72A An entity's right to defer settlement of a liability for at least twelve 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 condition at the end of the reporting period even if the lender does not test compliance until a later date.** (**emphasis added**)

When the IASB issued the amendments to IAS 1, it also added paragraphs BC48A and BC48D to the Basis for Conclusions:

BC48A Paragraph 69(d) specifies that, to classify a liability as non-current, an entity must have the right to defer settlement of the liability for at least twelve months after the reporting period. In January 2020, the Board amended aspects of this classification principle and related application requirements in paragraphs 73–76. **The Board made the amendments in response to a request to reconcile apparent contradictions between paragraph 69(d)—which required an 'unconditional right' to defer settlement—and paragraph 73—which referred to an entity that 'expects, and has the discretion, to' refinance or roll over an obligation** [**emphasis added**].

BC48D The Board considered whether an entity's right to defer settlement needs to be unconditional. The Board noted that rights to defer settlement of a loan are rarely unconditional—they are often conditional on compliance with covenants. **The Board decided that if an entity's right to defer settlement of a liability is subject to the entity complying with specified conditions, the entity has a right to defer settlement of the liability at the end of the reporting period if it complies with those conditions at that date.** Accordingly, the Board:

(a) deleted the word 'unconditional' from the classification principle in paragraph 69(d);
and,

(b) added paragraph 72A to **clarify that if an entity's right to defer settlement is subject to compliance with specified conditions**:

(i)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**; and

(ii)**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.**

[**emphasis added.**]

The Group considered the following fact pattern and discussed the impact of paragraph 72A of IAS 1 on classifying a loan in interim financial statements when a covenant test is not required under the contractual terms of the lending arrangement at the interim balance sheet date.

Fact Pattern

- Entity Y has a December 31, 20x3 year-end and is currently preparing its June 30, 20x3 interim financial statements in accordance with IAS 34 *Interim Financial Reporting*.
- Entity Y has a long-term bank loan that will be repayable in five years with a loan covenant specifying that the bank has the right to demand repayment immediately if Entity Y does not maintain a specified debt-to-equity ratio at each calendar year-end.
- The contractual terms of the bank loan stipulate that the bank will assess Entity Y's compliance with this covenant based on the audited financial statements. Entity Y's management must provide the audited financial statements by March 31 of the following calendar year.
- No conditions in the loan agreement apply as at June 30, 20x3. Therefore, Entity Y's compliance with this covenant will not be assessed by the bank as at June 30, 20x3.

Issue: How should Entity Y classify the bank loan in its interim financial statements when the covenant test is not required under the contractual terms of the loan?

View A – Entity Y should perform the covenant test as at June 30, 20x3 and classify the liability accordingly.

Proponents of this view acknowledge that the bank loan cannot be due on demand as at June 30, 20x3 regardless of the result from the covenant test performed on that date. This is because

contractually, the compliance with the covenant is based on the December 31, 20x3 figures. However, they note that amended paragraph 69(d) of IAS 1 requires a liability to be classified as current when an entity does not have the right at the end of the reporting period to defer settlement for 12 months. Furthermore, paragraph 72A of IAS 1 and paragraph BC48D in the Basis for Conclusions on IAS 1 are clear that the right to defer settlement must exist as at the end of the reporting period, even if the lender does not test compliance until a later date. The right to defer payment, proponents argue, exists only if Entity Y complies with the covenant test as at June 30, 20x3.

Therefore, Entity Y should perform the covenant test as at June 30, 20x3. If it fails the covenant test, the bank loan would be classified as current, even though the loan is not contractually due on demand.

View B – Entity Y should perform the covenant test as at December 31, 20x3 as specified in the loan agreement and classify the loan as non-current at June 30, 20x3

Proponents of this view think that the contractual terms only give the bank the right to demand repayment if Entity Y fails the covenant test at each calendar year-end. The bank does not have a contractual right to demand prepayment of the loan and the borrower does not have a contractual obligation to settle the liability on June 30, 20x3. Therefore, proponents of this view think applying View A to classify the loan as current does not reflect the contractual rights and obligations that are agreed to between the contracted parties.

Therefore, Entity Y would classify its bank loan as non-current as at June 30, 20x3 because it is not due for repayment in the next 12 months.

The Group's Discussion

Group members thought that the guidance in paragraph 72A of IAS 1 is unclear, such that both View A and View B might be appropriate.

Despite the lack of clarity, most Group members preferred View B. They thought that Entity Y has no condition to be complied with on June 30, 20x3 because the lending agreement only stipulates that the covenant be measured on December 31, 20x3. Thus, no covenant applies on June 30, 20x3 and the result from the covenant test performed on that date is irrelevant to the classification of the loan. Furthermore, some Group members were concerned that the outcome from applying View A (i.e. classify the loan based on the covenant test as at June 30, 20x3) may not faithfully represent Entity Y's financial position on June 30, 20x3. They considered a scenario where Entity Y is in a cyclical business with most sales occurring in the last quarter of the year. Applying View A could result in Entity Y failing the covenant at June 30, 20x3 although the entity is tracking to comply with the contractually required covenant test to be measured at December 31, 20x3. Under View A, Entity Y would classify the entire loan as current, even though there is no contractual test that applies on June 30, 20x3 and it expects to comply with the test at the year end. Group members thought that this outcome inaccurately portrays Entity Y's economic condition as at June 30, 20x3 to financial statement users as no actual breach of covenant occurred on that date. Some Group members further commented that classifying the loan as current as at June 30, 20x3 also reduces

the usefulness of the information reported to financial statement users as it alerts them to a problem that does not yet exist, or may never exist, given the covenant will only be tested on December 31, 20x3. One Group member observed that this classification outcome can have consequences, such as triggering other default clauses or violating debt covenants in other lending agreements. This Group member noted that the effort to monitor the compliance and to renegotiate contracts can be significant to an entity.

Some Group members acknowledged that View A appears to be supported by a literal reading of paragraph 72A. They also thought that paragraphs BC48D and BC48E in the Basis for Conclusions to IAS 1 support that the right to defer settlement for 12 months must exist as at the end of the reporting period, even if the lender does not test compliance until a later date. One Group member also thought that if the covenant is close to being breached during the year, the entity should use professional judgment and consider providing disclosures about the potential covenant breach and the mitigating action taken by management. A few Group members noted that in the fact pattern presented, the covenant is only required to be tested at a point in time. They thought that if the covenant is required to be complied with continuously, View A is more appropriate. Therefore, these Group members highlighted the importance for borrowers to have a clear understanding of the nature and frequency of covenant tests in loan agreements.

Several Group members then highlighted some practical challenges an entity may encounter under View A. One Group member noted paragraph BC48E in the Basis for Conclusions to IAS 1 does not prescribe a method to assess the compliance with a future covenant. As such, at June 30, 20x3, Entity Y may combine its financial projection for the rest of the year with its actual results year-to-date to assess its year-end covenant compliance. This Group member observed that classifying the loan as current vs non-current based on the result of a future covenant test is a change from current practice. Another Group member noted that in practice, many covenants in loan agreements are non-financial, such as a requirement to have the financial statements audited. This Group member thought that these types of non-financial covenants may not be met in the interim period which will result in the loan always being classified as current under View A. Finally, one Group member pointed out that View A will lead to a disconnect with the contractual maturity analysis disclosure requirement in IFRS 7 *Financial Instruments: Disclosures* which specifies that the entity should disclose the contractual maturities of its derivative and non-derivative financial liabilities.

Given the potential impact that paragraph 72A may have on the classification of term loans and its significant consequences to borrowers, Group members thought that further clarification from the IASB on applying this paragraph, such as through publications of educational materials or illustrative examples would be helpful. As a result, they recommended that this issue be discussed with the AcSB to determine whether it should be raised to the IASB.