IAS 1: Classification of Debt with Covenants as Current or Non-Current

Extract, IFRS® Discussion Group Report on the Meeting – December 17, 2020

At its September 2020 meeting, the Group discussed the application of paragraph 72A of recently amended IAS 1 *Presentation of Financial Statements* (effective from 1 January 2023). The issue identified is how to determine whether a borrower has the right to defer settlement when a long-term liability is subject to a covenant and the borrower's compliance with the covenant is tested at future dates after the end of the reporting period.

The IFRS Interpretations Committee (the Interpretations Committee) discussed this issue at its December 2020 meeting. In the IFRIC agenda paper, the staff from the IFRS Foundation illustrated this issue using three scenarios. In each scenario, an entity has a loan that is repayable in five years. The loan is subject to a working capital ratio covenant that must be greater than a certain threshold and is due on demand if this ratio is not met. The three scenarios presented in the IFRIC agenda paper are as follows:

	Case 1	Case 2	Case 3	
Required working capital ratio	above 1.0	above 1.0	above 1.0	above 1.1
Testing date	each 31 December, 31 March, 30 June, and 30 September	each 31 March	31 December 20X1	30 June 20X2 and each 30 June thereafter
Conditions at 31 December 2X1 (the reporting date)	Working capital ratio is 0.9	Working capital ratio is 0.9	Working capital ratio is 1.05	
	The entity obtains a waiver for the breach before 31 December 20X1. The waiver is for three months. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).	The entity expects the working capital ratio to be above 1.0 at 31 March 20X2.	The entity expects the working capital ratio to be above 1.1 at 30 June 20X2.	

(Source: IFRS Interpretations Committee, Agenda Paper 2 (December 2020), page 5)

In all three cases, the staff from the IFRS Foundation thought the entity is required to classify the loan as a current liability because it does not have the right at the end of the reporting period to defer settlement of the loan for at least 12 months after the reporting period. They also concluded that an entity's expectation that it will meet the condition to be tested after the reporting period does not affect this assessment. Therefore, to be classified as non-current on December 31, the future working capital ratio covenants required for the next 12 months need to be met as at the December 31 reporting date, even though:

(a) non-compliance on December 31 was waived by the lender (see Case 1);

(b) compliance with the test is not required on December 31 (see Case 2); and

(c) the required test on December 31 is met but is followed by a more stringent test within 12 months that is not met on December 31 (see Case 3).

At its meeting, the Interpretations Committee generally agreed that the staff's conclusions reflected appropriate interpretation of the amended guidance as applied to those three scenarios. Interpretations Committee members also found the examples to be helpful to their understanding of the effects of the amendments.

The Interpretations Committee agreed that a tentative agenda decision should be published, substantially as proposed by the staff. The tentative agenda decision presents the three scenarios described above and summarizes the Interpretations Committee's rationale for concluding that the loans should be presented as a current liability in all three cases. It also reports the Interpretations Committee's tentative conclusion that principles and requirements in IAS 1 provide an adequate basis for determining the appropriate accounting in the three cases and its tentative decision not to add a standard-setting project to the work plan.

Considering the Interpretations Committee's recent discussion on December 1, 2020, the Group continued its discussion on the issue at this meeting. Specifically, Group members discussed whether the guidance in IAS 1 and the tentative agenda decision can be applied consistently to fact patterns that differ from the three scenarios described in the tentative agenda decision. In addition, the Group discussed challenges entities may face when implementing the guidance in IAS 1 and the tentative agenda decision.

Applying IAS 1 and the tentative agenda decision to a debt covenant that is related to financial performance as opposed to financial position

Fact Pattern for Issue 1

This fact pattern is similar to the fact pattern described in Case 3 in the IFRIC agenda paper, except:

(a) Instead of working capital ratio being the covenant, the covenant that must be met is based on a 12-month rolling earnings before interest, tax, depreciation and amortization (EBITDA). The EBITDA covenant must be measured at the entity's December 31 year-end and at each quarter end.

(b) The covenant requires that the company maintain EBITDA on a rolling 12-month basis as follows:

- At each of December 31, 20X3 and March 31, 20X4, the 12-month EBITDA should be at least $10 million.

- At each of June 30 and September 30, 20X4, the 12-month EBITDA should be at least $15 million.

(c) On December 31, 20X3, EBITDA for the last 12 months is $12 million and, based on the entity's budgets, the expectation is that EBITDA for the 12 months ended June 30, 20X4 is expected to be $17 million. The entity's budgeting process is subject to robust controls and the budget information is used for other accounting purposes, such as evaluation of impairment under IAS 36 *Impairment of Assets*.

Issue 1: How should the entity classify the loan on its balance sheet as at December 31, 20X3?

View 1A – The loan may be classified as non-current

- Proponents of this view refer to paragraph BC48E of the Basis for Conclusions to IAS 1 and think it explains that the standard permits the entity to make some adjustments when evaluating its compliance with future covenants as at December 31, 20X3. As noted in paragraph BC48E, the IASB decided not to specify how to make such an adjustment but it seems possible that there may be alternative methods that could result in different conclusions as to whether the future test could be considered to be met at December 31.
- Proponents of this view acknowledge that it differs from the Interpretations Committee's conclusion to classify the debt as current for Case 3 in the IFRIC agenda paper. However, they note that paragraph BC48E specifically addresses financial performance tests which are different than the financial position tests described in Case 3 in the IFRIC agenda paper.

View 1B – The loan would be classified as current

- Proponents of this view think the requirements in paragraph 72A of IAS 1 are clear that the covenant tests to be performed in the next 12 months must also be met as at the reporting date. If these future tests are not met at the reporting date, then the entity cannot demonstrate that it has the right to defer settlement beyond 12 months from the reporting date.
- Proponents of this view also note that the Basis for Conclusions is not part of the IFRS Standard. In addition, paragraph BC48E is likely referring to circumstances in which an entity's actual performance up to the end of the reporting period reflects a shorter period of performance than specified in the covenant (e.g. the actual EBITDA for nine months and a covenant requiring a 12-month rolling EBITDA). Thus, paragraph BC48E does not address the situation described in the fact pattern.
- As a result, based on the 12-month rolling EBITDA measured on December 31, 20X3, the future covenant requirements as at June 30 and September 30, 20X4, are not met. The loan should be classified as current as at December 31, 20X3.

View 1C – The guidance in IAS 1 is unclear and different interpretations are possible

- Proponents of this view note that the guidance in IAS 1 and in paragraph BC48E of the Basis for Conclusions to IAS 1 are unclear and inconsistent, which can result in different interpretations and inconsistent application.

The Group's Discussion

Group members who expressed a view supported View 1C, noting that the interaction between paragraph 72A of IAS 1 and paragraph BC48E in the Basis for Conclusions to IAS 1 is unclear, which could result in different interpretations and inconsistent application.

Group members acknowledged that the three cases included in the tentative agenda decision bring some clarity in the application of IAS 1 to financial position-type covenants. However, some Group members thought that the applicability of the tentative agenda decision is limited, because it does not address covenants relating to financial performance conditions or those relating to both financial position and financial performance conditions. One Group member noted that, although the working capital requirement in Case 3 of the IFRIC agenda paper relates to the entity's financial position, the more stringent requirement later in the year incorporates the entity's expected future performance. Another Group member raised a similar example for a covenant based on equity and thought that in assessing the compliance with such covenant, the entity may need to incorporate its future financial performance. These Group members thought additional examples illustrating how to distinguish between financial position and financial performance covenants would be helpful to improve consistency in application of the amendments.

Some Group members also noted that paragraph BC48E does not specify the adjustment method or the situations in which some adjustments are inappropriate. As a result, alternative methods can be applied to two identical loans, which could result in different conclusions as to whether the future covenant test could be met as at the reporting date. These Group members questioned whether the different accounting outcomes provide useful information to financial statement users.

A few Group members expressed concern that, without any further changes to IAS 1, View 1B may be the only acceptable view based on how paragraph 72A of IAS 1 is currently worded, even though many would believe that View 1A provides a more relevant and faithful representation of the entity's obligation to repay the loan.

Applying IAS 1 and the tentative agenda decision to non-financial covenants

The Group then discussed how the amended IAS 1 should be applied to non-financial covenants such as the requirement to file audited financial statements and the requirement to complete reserve reports by companies in the extractive industries.

The Group's Discussion

Some Group members noted that the guidance in IAS 1 and the tentative agenda decision is unclear on how the principles in IAS 1 should be applied to non-financial covenants. They compared Case 2 in the tentative agenda decision, which requires testing of a working capital ratio on a future date to a scenario where an entity is required to file audited annual financial statements. If the principle applied to arrive at the decision to classify the loan as current in Case 2 is applied to this non-financial covenant, then the loan would also need to be classified as current because the financial statements will not have been audited as at the financial reporting date. Considering that it is common for loan agreements to include non-financial covenants that will be satisfied at future dates, these Group members were concerned that entities will need to classify all outstanding loans as current. They also thought this outcome does not provide an accurate depiction of the financial position of the entity to financial statement users.

Other challenges entities may face when implementing the guidance in the amended IAS 1 and the tentative agenda decision

Some challenges entities may face when implementing the guidance in IAS 1 and the tentative agenda decision include:

- The need to evaluate compliance with future covenants is inconsistent with how lenders will be testing the covenants. For example, in Case 2 in the IFRIC agenda paper, where the covenant is tested only once per year on March 31, the accounting standards are establishing the need to test at December 31, even though the lender did not design the test to be done at that time. Thus, the accounting requirement seems to negate the will of the parties to the loan agreement and what they agreed to with respect to the timing of the test.
- To continue to classify debt as long term, the borrower may need to ask the lender to waive their rights to call the debt in response to covenant breaches that might occur in the 12 months after the reporting date. Lenders may not be willing to do this.
- Seasonality may affect how the covenants are designed and could be the reason, for example, why in Case 3 the June 30 covenant test required a higher working capital ratio than was required at December 31. The accounting guidance seems to go against these practical considerations and may penalize seasonal businesses based on how the covenants are designed.
- The borrower's balance sheet can become more volatile when the classification of its debt changes frequently. For example, in Case 3 in the IFRIC agenda paper, the balance sheet on December 31, 20X3 will show the debt as current (even though the required test at that date is met) only to be reclassified to non-current if the entity meets its expectation to pass the more stringent test on June 30. Some might question the relevance of such reclassification, especially when the borrower was never technically in breach of a covenant.
- The financial statements may not clearly distinguish whether the loan is classified as current because the borrower has breached the loan covenant as at the balance sheet date or because the borrower may breach a covenant that is to be tested at a future date. Furthermore, the balance sheet could lead to the expectation that a payment will be made in the next 12 months, which may be inconsistent with other disclosures, such as those related to liquidity and the entity's ability to continue as a going concern.

- Classifying the loan as current can have business impacts if it causes covenants on other debts or contractual arrangements to be breached. One might question if this is appropriate when the debt reclassification to current is related to a future test, especially one that the entity is not likely to fail.

The Group's Discussion

Group members agreed with the challenges noted above when implementing the guidance in IAS 1 and the tentative agenda decision.

Some Group members noted that under Case 2 described in the IFRIC agenda paper, the borrower would have difficulties to obtain a waiver from the lender on the covenant that does not, per the loan agreement, need to be tested at the financial reporting date. Furthermore, one Group member observed that by implementing the tentative agenda decision, borrowers may choose to renegotiate lending agreements and covenants with their lenders and that such process takes time and may be costly to both sides. This Group member noted that the efforts spent by the lender and borrower do not provide significant economic benefits to the borrower given they had expected the covenant to be met. One Group member observed that if the negotiation results in a less stringent covenant, the lender could see its risk increased in the loan and may want to be compensated through a higher interest rate, which can have a significant impact on the borrower's business.

Some Group members noted that classifying the loan as current will create 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. They thought this inconsistency may be counter-intuitive to the financial statement users. A representative from the Canadian Securities Administrators (CSA) commented that there are various securities legislative requirements for issuers and registrants to disclose their working capital balances, such as the management discussion and analysis (MD&A), the prospectus, and the rights offering circular. Classifying the loan as current without the expectation to have a cash outflow related to the loan within the next 12 months represents an inconsistency with the policy rationale that requires the working capital disclosure. As a result, when working capital does not reflect the expected cash outflows for the next 12 months, issuers may need to provide additional explanation and disclosures in their filings to explain this inconsistency to the readers of these filings.

Overall, Group members thought that the principles expressed in the IAS 1 amendments are difficult to understand. In addition, they questioned the relevance and usefulness of the financial information produced to classify the loan as current when the lender as at the financial reporting date, does not have the contractual right to demand repayment of the loan, nor is it expected to have that right in the next 12 months. Therefore, Group members thought additional clarifications on the IAS 1 amendments and the tentative agenda decision are needed to address these concerns. Considering that the issues discussed are likely to be even more significant to Canadian companies with quarterly financial reporting requirements, Group members strongly encouraged financial statement preparers and users to respond to the tentative agenda decision. The AcSB Chair also noted that the AcSB decided at its December 16, 2020 meeting to formally respond to this tentative agenda decision before the comment deadline of February 15, 2021 and will consider Group member's feedback when drafting its response letter. No further action was recommended to the AcSB.