Classification of Liabilities with Covenants when an Entity is Granted a Waiver or Grace Period

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Background

In October 2022, the IASB issued *Non-current Liabilities with Covenants* (Amendments to IAS 1) (the “October 2022 amendments”). The October 2022 amendments aimed to improve the information an entity provides when its right to defer settlement of a liability is subject to compliance with covenants within 12 months after the reporting period. These amendments are effective for annual reporting periods beginning on or after January 1, 2024, with earlier application permitted.

Pursuant to the October 2022 amendments, an entity classifies a liability as current if it does not have the right, at the end of the reporting period, to defer its settlement for at least 12 months after the end of the reporting period. A liability is also classified as current when it is not scheduled for repayment within 12 months of the end of the reporting period but can be called by the lender at any time without cause.

Lenders often include conditions in loan arrangements (hereafter referred to as “covenants”). Covenants that an entity must comply with only after the reporting date would not affect the classification of a liability as current or non-current at the reporting date. However, those covenants that an entity is required to comply with on or before the reporting date would affect their classification as current or non-current, even if the covenant is only assessed after the entity’s reporting date.

The October 2022 amendments also introduced a new disclosure requirement for liabilities arising from loan arrangements that are classified as non-current when the entity’s right to defer settlement of those liabilities is subject to the entity complying with covenants within 12 months after the reporting period. In such situations, an entity shall disclose information in the notes that enables users of financial statements to understand the risk that the liabilities could become repayable within 12 months after the reporting period. These disclosures include:

(a) information about the covenants (including the nature of the covenants, when the entity is required to comply with them, and the carrying amount of the liability); and

(b) 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 based on its circumstances at the end of the reporting period.

Fact Pattern 1

- An entity enters into a loan arrangement with a covenant requiring the entity to maintain a total debt-to-shareholders' equity ratio of less than 75 per cent at each quarter end.
- If the entity expects that they are at risk of violating the debt covenant, they may ask the lender to waive the covenant reporting requirements before the testing date, or to provide them with a period of grace.
- The loan has a remaining maturity of three years at the reporting date.

Issue 1A: How should the entity classify the related borrowings when the lender has provided a waiver before the testing date?

Analysis

Since the lender granted a waiver to the entity before the testing date, this has amended the loan agreement and removed the covenant requirement for that reporting period. The lender does not have an enforceable right to call the loan even if the entity would have been in breach of the covenant on the reporting date. The entity would classify the loan as non-current at the end of the reporting period.

The Group's Discussion

The Group agreed with the analysis.

Issue 1B: How should the entity classify the related borrowings when the lender has provided a period of grace before the testing date?

Analysis

Since the lender did not grant a waiver to the entity before the testing date, the entity breached the loan covenant on the testing date. Since the entity breached the loan covenant, the lender has an enforceable right to repayment of the loan at the end of the period of grace. Therefore, the classification of the loan as current or non-current depends on the length of the period of grace granted to the entity. If the period of grace is greater than 12 months after the balance sheet date, the entity would present the loan as non-current. If the period of grace is less than 12 months after the balance sheet date, the entity would present the loan as current.

The Group's Discussion

The Group agreed with the analysis.

Fact Pattern 2

- An entity enters into a term loan arrangement that includes a provision they must sell a foreign branch of their operations by December 31, 20X0.
- The terms of the loan agreement state that the entity is permitted an additional two months to complete the sale if it is not able to sell the branch by the specified date.
- As of December 31, 20X0, the entity has not sold the branch.

- If the entity is unable to complete the sale by February 28, 20X1, the lender can demand repayment of the loan.
- The entity has a December 31 reporting date.
- The loan has a remaining maturity of three years at the reporting date.

Issue 2: How should the entity classify the term loan?

Analysis

The classification of the loan as current or non-current depends on whether the entity was granted a period of grace. Since IAS 1 does not define “period of grace,” an entity must apply judgment to determine if a period of grace was provided.

In this fact pattern, the original contractual provisions allow the sale of the foreign branch to be completed by February 28, 20X1. Therefore, a period of grace was not required on December 31 to avoid a covenant breach. The entity can continue to classify the loan as non-current at the reporting date because the covenant does not affect the entity’s right to defer payment of the liability at the end of the reporting period.

If, however, the contractual provisions had required the entity to sell the foreign branch by December 31, or obtain written approval from the lender to defer this requirement until February 28, this would be considered a period of grace. In this case, the entity would be required to classify the term loan as current at the balance sheet date because the period of grace would have been less than 12 months after the balance sheet date.

The Group’s Discussion

Some Group members thought that the condition in the loan agreement for the borrower to sell their foreign branch by December 31, 20X0, is not a substantive requirement. They noted that the lender did not have a contractual right to call the loan as at December 31, 20X0, based on the fact pattern presented in the paper and that the testing date for the loan condition was really February 28, 20X1. Therefore, they thought that the loan should be presented as non-current at the balance sheet date.

One Group member noted that they often see similar fact patterns involving loan agreements with financial covenants, and that these types of arrangements are more common than the one presented in this agenda paper. In these loan agreements, the borrower is typically required to comply with a financial covenant at year-end, and the loan agreement provides a pre-negotiated period of grace for the entity to rectify a breached covenant. The year-end financial covenant in these arrangements is normally considered substantive, and the borrower is required to test the covenant for a breach at the balance sheet date. The loan would need to be presented as current if the covenant is breached and the pre-negotiated period of grace is less than 12 months after the balance sheet date. This Group member indicated that entities should consider the nuances in their loan agreements to determine if a substantive covenant exists at year-end. They noted that a pre-

negotiated period of grace in the loan agreement does not normally indicate that a year-end loan covenant is not substantive.

Fact Pattern 3

- An entity enters into a term loan arrangement that includes a provision that the borrower must repay the loan if a specified revenue target is not attained by the end of each quarter.
- The entity's sales are reported to the lender in annual and interim financial statements.
- The entity obtained a waiver from the lender before the end of the fourth quarter of 20X0 because they did not expect to meet the specified revenue target. This waiver only covers the fourth quarter of 20X0.
- The entity also expects that it will not meet the revenue target for the first quarter of 20X1.
- The loan has a remaining maturity of three years at the reporting date.
- The loan balance is material to the entity and early repayment would significantly affect the borrower's liquidity position.

Issue 3A: How should the entity classify the related loan as at December 31?

Analysis

Since IAS 1 does not define the term "covenant", an entity must apply judgment to determine if a condition in a loan agreement is a loan covenant. A covenant is typically intended to protect a lender by granting it a right to call a loan earlier than the contractual maturity date when the borrower does not meet certain conditions. These conditions typically relate to the borrower's financial condition or performance, and early repayment is triggered when there has been a deterioration in the conditions. In this fact pattern, the minimum revenue target would likely be considered a loan covenant.

When an entity is required to comply with a loan covenant on or before the reporting date, this requirement affects the classification of the loan as current or non-current, even if the covenant is assessed only after the entity's reporting date. In this fact pattern, the entity breached the loan covenant on December 31, 20X0, because they did not meet the specified revenue target by the end of the quarter. However, the entity obtained a waiver from the lender before the end of 20X0 and, therefore, the lender agreed not to demand repayment of the loan as a result of the breach. The entity should classify the loan as non-current as at the reporting date.

The Group's Discussion

The Group agreed that an entity must apply judgment to determine if a condition in a loan agreement is a loan covenant. The Group also noted that in some circumstances an entity must apply judgment to determine whether an agreement to defer the application of a loan covenant means there was:

(a) no breach of the covenant;

(b) a breach of the covenant and a waiver thereof was obtained before the balance sheet date; or
(c) a breach of the covenant and a period of grace to rectify it was obtained before the balance sheet date.

An entity's assessment of which of the above scenarios applies might impact the analysis. The Group clarified that in Fact Pattern 3 there was either no covenant breach or a covenant breach and a waiver thereof before the balance sheet date, but no new covenants were inserted. The entity is then required to test the same loan covenant at the end of the first quarter to meet the recurring covenant requirements in the loan agreement. Some Group members thought that this arrangement is economically similar to one where there was a covenant breach, and an entity is granted a three-month period of grace to rectify that breach because the requirement to comply with the future covenant is intrinsically linked to the entity's waived covenant at year-end. However, most Group members thought that, in Fact Pattern 3, the pre-existing loan covenant at the end of the first quarter is a future covenant that should not impact the classification of the loan as current or non-current at year-end.

One member questioned whether Group members' views would change if the entity breached the year-end covenant, but then the lender waived the application of this covenant and imposed a new covenant that the entity must comply with at the end of the first quarter. They noted this arrangement is different than the one in Fact Pattern 3 because the covenant requirement at the end of the first quarter in this case was not part of the original loan agreement. Most Group members agreed that there is ambiguity as to whether this arrangement is a three-month period of grace or a waiver with the imposition of a new future covenant. If this arrangement is viewed as a three-month period of grace, the Group noted that the loan would need to be classified as current because the entity does not have the right to defer its settlement for at least 12 months. However, if it is viewed as a waiver with the imposition of a new future covenant, the Group noted that the loan would be classified as non-current because the lender does not have an enforceable right to call the loan unless the entity breaches the covenant in the following quarter. Therefore, some Group members thought that economically similar arrangements may lead to different accounting outcomes.

Issue 3B: What are the disclosure considerations following the October 2022 amendments?

Paragraph 76ZA of IAS 1 introduced new disclosure requirements for debt with covenants. When an entity classifies a liability arising from a loan arrangement as non-current, and that liability is subject to covenants that an entity is required to comply with within 12 months of the reporting date, the entity shall disclose information in the notes that enables users of financial statements to understand the risk that the liability could become repayable within 12 months of the reporting period. To comply with the new disclosure requirements, the entity might need to disclose:

(a) the carrying amount of the loan subject to the covenant;
(b) details of the covenant;

(c) the fact that the entity requested and has received a waiver from the lender for the fourth quarter revenue target to avoid a potential breach;

(d) the fact that, without the waiver obtained, the borrower would not have complied with the covenant if it were to be assessed for compliance based on the borrower's circumstances at the end of the reporting period; and

(e) circumstances that indicate the borrower may have difficulty complying with the covenant for the first quarter of the following year and the risk that the loan could become repayable within 12 months after the reporting period.

The Group's Discussion

The Group agreed with the disclosures that an entity would need to provide to comply with the October 2022 amendments when an entity classifies a liability as non-current, and that liability is subject to covenants that an entity is required to comply with within 12 months of the reporting date. One Group member noted that the disclosure requirements in paragraph 76ZA(b) of IAS 1 might require an entity to disclose sensitive information about their revenue forecasts and the probability that they will comply with the future covenant requirements. Some Group members noted that entities might also need to consider the disclosure requirements in other standards when there is a risk that their lender will call a loan. For example, they might need to consider the liquidity risk disclosures in IFRS 7, or the disclosure of significant doubt upon the entity's ability to continue as a going concern in IAS 1.

Fact Pattern 4

- An entity enters into a term loan arrangement with repayment terms based on a percentage of revenue for each fiscal year.
- The entity's sales are reported to the lender in annual and interim financial statements.

Issue 4: How should the entity classify the related loan as at December 31?

Analysis

Loan arrangements might include various conditions that specify when debt repayments are due. Since IAS 1 does not define the term "covenant", an entity must apply judgment to determine whether a loan condition is a covenant. If the repayment conditions are considered covenants, an entity applies the guidance in paragraph 72B of IAS 1 to determine whether the loan should be classified as current or non-current. If the repayment conditions are not considered covenants, paragraph 72B of IAS 1 does not apply.

View 4A – The entire loan balance should be classified as current

Although the term "covenant" is not defined in IAS 1, loan covenants are typically included in loan arrangements to protect the lender from increased credit risks of the entity. In this fact pattern, the conditions specified in the loan arrangement do not appear to be mechanisms designed to protect the lender from increased credit risk. Conversely, increased revenue by the entity will accelerate loan repayments, even though the entity's credit risk has not increased. Therefore, the relationship

between revenue and loan repayments in this fact pattern does not appear to be a covenant and paragraph 72B of IAS 1 does not apply.

Since paragraph 72B does not apply, other paragraphs of IAS 1, as amended, will apply. Paragraph 69(d) of IAS 1 indicates that an entity classifies a liability as current when it does not have the right at the end of the reporting period to defer settlement of the liability for at least 12 months after the reporting period. Furthermore, paragraph 72A of IAS 1 indicates that an entity's right to defer settlement of a liability for at least 12 months after the reporting period must have substance. In this fact pattern, the entity's right to defer payment of the loan for at least 12 months from the end of the reporting period does not have substance. If it is assumed that the entity is a going concern, the entity would be expected to make future sales and might have committed sales contracts in place. The fact that the lender agreed to a repayment schedule based on a percentage of revenue as opposed to a fixed repayment schedule does not mean that the entity has a substantial right to defer settlement for at least 12 months after the end of the reporting period.

One might consider whether paragraph 75A of IAS 1 applies to this fact pattern. Paragraph 75A states that a liability is classified as non-current even if management intends or expects to settle the liability within 12 months after the reporting period. However, proponents of this view think that the guidance in paragraph 75A pertains to voluntary repayments only. In this fact pattern, the entity's deferral of repayment beyond 12 months is not voluntary, but rather it is based on the contractual terms of the loan. Therefore, they think that paragraph 75A does not apply to this fact pattern.

Proponents of this view also note that the entity's requirement to make loan repayments over the next 12 months is known. However, the amount that the entity will be required to repay is not known. Since the entity is unable to measure the amount of the loan for which they have a right to defer settlement for at least 12 months after the reporting period, the balance should be classified as current.

View 4B – A portion of the loan balance should be classified as current

For the same reasons outlined in View 4A above, the loan agreement does not include a covenant, and paragraph 72B of IAS 1 does not apply.

Proponents of this view think that presenting the entire loan balance as current would not accurately depict the borrower's repayment obligation over the next 12 months. Instead, they think that the entity should classify a portion of the loan as current based on management's estimate of sales within 12 months of the reporting period. The remaining balance would be presented as non-current. Additional disclosures may be required if there is significant measurement uncertainty associated with determining the current balance of the loan.

View 4C – The entire loan balance should be classified as non-current

Proponents of this view note that paragraph 72B of IAS 1 refers to conditions that give rise to an entity's right to defer settlement of a liability arising from a loan arrangement for at least 12 months after the reporting period. They think that these conditions can be broader than mechanisms designed to protect the lender in case of an increase in the entity's credit risk. For example, the

entity's right to defer repayment of the loan until it records revenue would be considered a condition specified in the loan agreement within the scope of paragraph 72B.

Proponents of this view also note that paragraph 75A of IAS 1 specifies that the classification of a liability as current should be unaffected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least 12 months after the reporting period. A liability that meets the definition of non-current is classified as non-current even if management intends or expects the entity to settle the liability within 12 months after the reporting period (i.e., the current portion of debt should not be "estimated").

As at the balance sheet date, future revenue is a condition that has not yet arisen. Therefore, proponents of this view think that the entity should record the entire loan balance as non-current until loan repayments are triggered when the entity records revenue. They think that any current liability recognized at the balance sheet date should be only in relation to revenue recognized prior to the end of the reporting period.

View 4D – Policy choice

Proponents of this view note that IAS 1 does not clearly define what is considered a covenant within the scope of paragraph 72B. Instead, paragraph 72B refers to "conditions", which may be interpreted quite broadly. They think that an entity would need to develop an accounting policy for how they apply the requirements in paragraph 72B and apply this policy consistently to similar facts and circumstances. The entity would also need to disclose this accounting policy choice if it is a significant accounting policy for the entity.

The Group's Discussion

The presenter of the paper clarified that in this fact pattern, the entity makes loan repayments on a quarterly basis based on sales reported in the prior quarter. For example, revenue reported in the fourth quarter triggers a loan repayment in the first quarter of the following year. Group members expressed diverse views on how the entity should classify the loan, and several Group members thought that each of the views had merit. The Group thought that any loan repayment obligations that were triggered as a result of past sales should be presented as current. However, the Group members discussed how the entity should classify the remaining loan balance when repayment obligations will be triggered by future sales.

Some Group members agreed with View 4A because they thought a liability should be classified as current unless there is evidence that the entity has the right to defer its settlement for at least 12 months. They noted that the entity is unable to prove that they have the right to defer settlement of the liability for at least 12 months because future sales are unknown to the entity until they occur. However, several Group members thought that presenting the entire loan as current is not useful to financial statement users unless management expects to fully repay the loan within 12 months. One Group member thought that the entity's right to defer settlement of a portion of the loan for at least 12 months might have substance if management does not have a realistic expectation that the entity will earn enough revenue to trigger a full repayment of the loan within that time.

Some Group members agreed with View 4C because the entity is only required to make loan repayments within the next 12 months once sales revenue is recorded. However, several Group members also thought that presenting the entire loan as non-current is not useful to financial statement users unless management does not expect to make any sales within the next 12 months. They noted that the entity will almost certainly be required to make some loan repayments within the next 12 months if it is an operating entity with a revenue stream.

Several Group members thought that View 4B results in information that is most useful to financial statement users. They also thought that presenting a portion of the loan as current based on management's estimate of sales over the next 12 months would most accurately depict the borrower's repayment obligation in the following year. However, one Group member noted that paragraph 75A of IAS 1 (as amended) and BC48C(b) in the Basis for Conclusions indicate that classification of the loan as current or non-current is unaffected by management intentions or expectations. One meeting participant noted that the application guidance in paragraph B5.4.6 in IFRS 9 requires an entity to adjust the amortized cost of a financial liability to reflect revised estimated contractual cash flows when an entity revises its estimates of payments. Since entities are required to factor expected future payments into the measurement of their financial liabilities, he questioned whether the same principle should apply to their classification as current or non-current. However, a group member noted that loans classified as current under IAS 1 due to a covenant breach are not necessarily remeasured under IFRS 9 as IFRS 9's amortized cost model considers the expected timing of the payments whereas the IAS 1 classification model is based on rights at the end of the reporting period to defer settlement for at least twelve months.

Overall, the Group's discussion raised awareness of views on the application of the October 2022 amendments to IAS 1 on non-current liabilities with covenants when an entity is granted a waiver or grace period. The Group noted that there are diverse views on how to apply these amendments to different fact patterns, and how to determine whether an arrangement is considered a waiver, a period of grace, or a waiver with a new future covenant. The Group recommended that this topic be included on the December 2023 agenda so that the Group can discuss whether any consensus has emerged on these matters. The Group noted that the IASB might not have contemplated Issue 4 when they issued the October 2022 amendments to IAS 1. Therefore, the Group recommended that the AcSB staff discuss this Issue with the IASB staff to determine how the IASB intends the guidance in IAS 1 to be in applied in similar fact patterns.