IAS 1 Classification of Liabilities with Covenants when an Entity is Granted a Waiver or Period of Grace

Extract, IFRS® Discussion Group Report on the Meeting – December 12, 2023

BACKGROUND

At its September 2023 meeting, the IFRS Accounting Standards Discussion Group discussed various scenarios and examples of the application of the 2022 amendments to IAS 1 on non-current liabilities with covenants when an entity is granted a waiver or period of grace. The Group noted that there were 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. Accordingly, the Group continued this discussion by considering how the timing of a waiver affects the classification of a loan as current or non-current.

The term "waiver" is not defined in IAS 1. However, it is generally considered to mean that a lender has relinquished its right to apply covenant provisions in a contract. When a lender grants a waiver to a borrower, the contractual terms of the loan are modified, and the covenant subject to the waiver does not apply.

The term "period of grace" is also not defined in IAS 1. However, paragraph 75 of IAS 1 refers to periods of grace by explaining that:

An entity classifies a 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.

A period of grace is generally considered a period of time during which a lender agrees not to demand repayment of a loan even though the borrower breached a loan covenant. Lenders often provide periods of grace to borrowers to give them time to rectify a breach. Once a period of grace has elapsed, a lender typically regains all the rights related to the covenant breach before the period of grace was granted. This differs from a waiver because a period of grace is generally time-limited, and the lender has discretion as to whether it will demand repayment of the loan once the period of grace has elapsed. It may be challenging for entities to determine whether an arrangement is a waiver or a period of grace because lenders may not clearly explain which rights they surrendered, and whether they are time-limited or contingent on future events.

For the purposes of determining whether the loan in this discussion should be classified as current, the Group assumed that the criteria in paragraphs 69(a)-69(c) of IAS 1 are not applicable. Therefore, the Group focused on whether the criteria in paragraph 69(d) of IAS 1 applies—that is,

determining whether an entity has the right at the end of the reporting period to defer settlement of the liability for at least 12 months after the reporting period.

Fact Pattern 1

- Entity A obtained a loan on January 1, 20X0. The loan is repayable in full on December 31, 20X5, with no periodic repayments of the principal until the due date.
- Entity A has a calendar year-end.
- The loan agreement includes a covenant that requires Entity A to maintain a debt-to-equity ratio no greater than 1.0 as at October 31 of each year. If Entity A fails to comply with this covenant, the lender has the right to demand immediate repayment of the loan until the next covenant testing date, unless the lender waives this right.
- On October 15, 20X3, Entity A informs the lender that it thinks it will not meet the covenant requirements on the upcoming testing date. As a result, the lender waives its rights with respect to the October 31, 20X3 covenant test. Therefore, even if Entity A's debt-to-equity ratio exceeds 1.0 on October 31, 20X3, the lender will not have the right to demand immediate repayment of the loan.
- As a condition of this waiver, the lender requires Entity A to comply with a new covenant on March 31, 20X4. The new covenant was not part of the original contractual terms of the loan. If Entity A does not meet the new covenant requirements on March 31, 20X4, the lender will have the immediate right to demand repayment of the loan.

Issue 1: How should Entity A classify the loan as at December 31, 20X3?

Analysis

The classification of the loan as current or non-current depends on whether Entity A has the right at the end of the reporting period to defer settlement of the loan for at least 12 months after the reporting period. Since Entity A is required to comply with a loan covenant, it applies the guidance in paragraph 72B of IAS 1 as part of this assessment.

Paragraph 72B(a) of IAS 1 indicates that a covenant *affects* whether an entity has the right to defer settlement of a liability for at least 12 months after the reporting period if the entity is required to comply with the covenant on or before the end of the reporting period. Entity A is not required to comply with the loan covenant on or before the end of the reporting period because the lender waived its right to enforce the covenant before the October 31, 20X3, testing date. As a result of this waiver, the lender did not have the right to demand repayment of the loan regardless of Entity A's debt-to-equity ratio as at October 31, 20X3.

Paragraph 72B(b) of IAS 1 indicates that a covenant *does not affect* whether an entity has the right to defer settlement of a liability for at least 12 months after the reporting period if the entity is required to comply with the covenant only after the reporting period. Entity A is required to comply with the new covenant on March 31, 20X4, which is after the reporting period. Therefore, this

covenant does not affect whether Entity A has the right to defer settlement of the loan for at least 12 months, even though it could be required to repay the loan within 12 months if it fails the March 31, 20X4, covenant test.

Since Entity A has the right to defer settlement of the loan for at least 12 months after the reporting period, it should classify the loan as non-current as at December 31, 20X3. Since Entity A will be required to comply with a covenant within 12 months after the reporting period, it must apply the requirements in paragraph 76ZA of IAS 1 and 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.

The Group's Discussion

The Group agreed that Entity A should classify the loan as non-current as at December 31, 20X3, for the reasons highlighted in the analysis. One Group member emphasized that as long as a waiver is obtained before the balance sheet date, there is no covenant violation as at that date. Another Group member noted the importance of validating the terms of the waiver to ensure it provides a permanent relinquishment of the lender's right to demand repayment. If the waiver does not provide a permanent relinquishment of this right, this might impact the borrower's classification of the loan, depending on the facts and circumstances.

One Group member raised a consideration when the covenant testing date is after the reporting date but before the financial statements are issued i.e., a future covenant is tested in the subsequent events period (e.g., a March 31 20X4 testing date, and a venture issuer with a 120-day reporting deadline). They noted that an entity in this situation would know whether they have violated the future covenant before their year-end financial statements are issued. If the entity breaches the covenant before the issuance date, the risk that the liability could become repayable within twelve months is no longer a risk, but a fact. Therefore, they thought that the new disclosure requirements under paragraph 76ZA could be addressed by reference to the disclosure requirements for non-adjusting subsequent events in paragraph 21 of IAS 10.

Fact Pattern 2

Assume the same fact pattern as Fact Pattern 1, except:

- Entity A tested and violated the covenant on October 31, 20X3. On November 5, 20X3, the lender waived its rights to demand repayment—that is, after the covenant violation occurred.

Issue 2: How should Entity A classify the loan as at December 31, 20X3?

Analysis

Similar to Issue 1, the classification of the loan as current or non-current depends on whether Entity A has the right at the end of the reporting period to defer settlement of the loan for at least 12 months after the reporting period. Since Entity A is required to comply with a loan covenant, paragraph 72B of IAS 1 also applies to this fact pattern.

When Entity A violated the terms of the loan agreement on October 31, 20X3, the lender had a contractual right to demand repayment of the loan. However, since the lender waived this right before the end of the reporting period, it did not affect whether Entity A had the right to defer settlement of the loan for at least 12 months as at December 31, 20X3. When assessing whether an entity has the right to defer settlement of a liability arising from a loan arrangement for at least 12 months, it does not matter whether the waiver is granted before or after the covenant is tested as long as the lender waives its right to demand repayment before the end of a reporting period. That is because the requirements in paragraph 72B of IAS 1 only consider the rights that exist at the end of the reporting period. As noted in the analysis of Issue 1, the new covenant inserted on March 31, 20X4, does not affect whether Entity A has the right to defer settlement of the loan for at least 12 months because Entity A is required to comply with it only after the reporting period. Therefore, similar to Issue 1, Entity A should classify the loan as non-current as at December 31, 20X3, because it has the right to defer its settlement for at least 12 months after the reporting period.

The Group's Discussion

The Group agreed that Entity A should classify the loan as non-current as at December 31, 20X3, for the reasons highlighted in the analysis. Some Group members observed varied application of IAS 1 for similar fact patterns due to unclear guidance in the standard before the October 2022 amendments. They noted that some entities classified the loan as non-current, and others as current. However, they think consensus is emerging on the application of the October 2022 amendments that will reduce diversity in the application of the requirements. One Group member highlighted that paragraph 72B(b) is particularly helpful for reducing diversity in the application of IAS 1 by emphasizing that the borrower shall only consider its rights at the balance sheet date when classifying a loan (i.e., covenants that an entity is required to comply with only after the reporting period do not affect an entity's right to defer settlement of a liability for at least 12 months after the reporting period).

Some Group members noted other factors an entity should consider when it obtains a waiver. One Group member thought that entities should review their other credit and loan agreements to determine if they contain any cross-default provisions, as the waiver might impact the classification of those loans. Another Group member noted that entities should consider whether the negotiation of the waiver will result in any changes to the risk, timing, or amount of contractual cash flows associated with the loan. If so, the entity may need to consider whether to apply the derecognition or modification guidance in IFRS 9 Financial Instruments.

Overall, the Group's discussion raised awareness of the consensus that is emerging on the application of the October 2022 amendments to IAS 1. The Group recommended monitoring this issue to determine if diversity in the application of the Standard continues after the amendments become effective in 2024. If so, the Group might consider discussing this issue again at a future meeting. No further actions were recommended to the AcSB.