STAFF PAPER

June 2021

IASB Meeting

Project	**Classification of Debt with Covenants as Current or Non-current (IAS 1)**
Paper topic	Background and report from the Committee

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Introduction and purpose

1. In January 2020, the International Accounting Standards Board (Board) issued *Classification of Liabilities as Current or Non-current*, which amended IAS 1 *Presentation of Financial Statements* (2020 amendments). The amendments clarified how an entity classifies debt and other financial liabilities as current or non-current in particular circumstances. The amendments are effective for annual reporting periods beginning on or after 1 January 2023, with earlier application permitted.

2. In December 2020, the IFRS Interpretations Committee (Committee) published a tentative agenda decision in response to informal feedback and enquiries about how an entity applies the amendments to particular fact patterns.

3. The Committee discussed the comments it received on the tentative agenda decision at its meeting in April 2021. The Committee confirmed its agreement with the technical analysis and conclusions in the tentative agenda decision. Nonetheless, before finalising the agenda decision, the Committee decided to report to the Board:

   (a) its technical analysis and conclusions on the matter; and

   (b) respondents' comments on the outcomes and potential consequences of applying the amendments, highlighting those that might provide information the Board did not consider when developing the amendments.

4. The purpose of this paper is to:

   (a) provide the Board with background to the 2020 amendments and a summary of the Committee's discussions; and

   (b) report to the Board the Committee's technical analysis and conclusions on the matter.

5. Agenda Paper 12C for this meeting includes a summary of feedback on the outcomes and potential consequences of applying the amendments, together with our analysis of that feedback.

Structure of the paper

6. This paper is structured as follows:

   (a) background to the 2020 amendments (paragraphs 8–11); and

   (b) summary of the Committee's discussions (paragraphs 12–27).

7. There are two appendices to this paper:

   (a) Appendix A—Excerpts from IAS 1 as amended in January 2020; and

   (b) Appendix B—Analysis of whether comments provide new information.

Background to the 2020 amendments

8. The 2020 amendments clarified how an entity classifies debt and other financial liabilities as current or non-current in particular circumstances. The discussion in this paper focuses on the amendments to paragraph 69(d) of IAS 1 and the added paragraph 72A.[1]

9. Paragraph 69(d) specifies 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 twelve months after the reporting period.

[1] Appendix A to this paper reproduces these and other relevant paragraphs from IAS 1 and its Basis for Conclusions, showing the amendments in marked text.

10. Paragraph 72A provides related application requirements:

> …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 conditions at the end of the reporting period even if the lender does not test compliance until a later date.

11. As explained in paragraphs BC48B and BC48D of the Basis for Conclusions on IAS 1 (reproduced in Appendix A), these amendments clarify that an entity's right to defer settlement of a liability for at least twelve months *must exist at the end of the reporting period*. To make that determination, the entity considers whether it complies with any conditions—to be met within 12 months—at the end of the reporting period, even if compliance is tested at a later date.

Summary of the Committee's discussions

Initial consideration of the matter and fact patterns considered

12. In December 2020, the Committee published a tentative agenda decision in response to informal feedback and enquiries about how an entity applies the amendments to particular fact patterns. Specifically, the Committee discussed how an entity, applying paragraph 69(d) of IAS 1, determines whether it has the right to defer settlement of a liability for at least twelve months after the reporting period when:

    (a) the right to defer settlement is subject to the entity complying with specified conditions; and

    (b) compliance with the specified conditions is tested at a date after the end of the reporting period.

    In the fact patterns discussed, it is assumed that the criteria in paragraph 69(a)–(c) of IAS 1 are not met.[2]

[2] Paragraph 69(a)–(c) of IAS 1 sets other criteria that, if met, result in the classification of a liability as current.

13. The Committee discussed three fact patterns with a loan that requires an entity to achieve a particular working capital ratio. In all three fact patterns, the entity assesses whether it classifies the loan as current or non-current as at 31 December 20X1:

(a) *Case 1*—an entity has a loan with the following contractual terms:

(i) the loan is repayable in five years (ie at 31 December 20X6).

(ii) the loan includes a covenant that requires a working capital ratio above 1.0 at each 31 December, 31 March, 30 June and 30 September. The loan becomes repayable on demand if this ratio is not met at any of these testing dates.

(iii) the entity's working capital ratio at 31 December 20X1 is 0.9 but the entity obtains a waiver before the reporting date with respect to the breach at that date. The waiver is for three months. Compliance with the covenant on the other testing dates continues to be required.

(iv) the entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).

(b) *Case 2*—the fact pattern is the same as Case 1, except:

(i) instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at each 31 March (ie the ratio is tested only once a year at 31 March). The loan becomes repayable on demand if the ratio is not met at any testing date.

(ii) the entity’s working capital ratio at 31 December 20X1 is 0.9. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2.

(c) *Case 3*—the fact pattern is the same as Case 1, except:

(i) instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at 31 December 20X1 and above 1.1 at 30 June 20X2 (and at each 30 June thereafter). The loan becomes repayable on demand if the ratio is not met at any of these testing dates.

(ii) the entity’s working capital ratio at 31 December 20X1 is 1.05. The entity expects the working capital ratio to be above 1.1 at 30 June 20X2.

13. The table below summarises the facts in these three cases.

		Case 1	**Case 2**	**Case 3**
Contract terms	Repayment date	31/12/20X6	31/12/20X6	31/12/20X6
	Testing dates	Each quarter-end	Each 31 March	31 December 20X1; then each 30 June
	Required working capital ratio	1.0	1.0	31 December 20X1: 1.0 Each 30 June: 1.1
Position at reporting date (31 December 20X1)	Working capital ratio	0.9	0.9	1.05
	Management expects to comply on testing dates?	Yes	Yes	Yes
	Additional information:	Before the reporting date, the entity obtained a waiver for three months	-	-

Committee's analysis and conclusions

14. The Committee concluded that, applying the requirements in IAS 1, the entity classifies the loan as *current* in all three fact patterns described in the tentative agenda decision. In all these fact patterns:

(a) the entity's right to defer settlement is subject to the entity complying with specified conditions tested after the reporting period; and

(b) the entity does not comply with such conditions at the end of the reporting period.

Therefore, applying paragraph 72A of IAS 1 (reproduced in paragraph 10 of this paper), the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.[3]

[3] Regarding case 1, the Committee also noted that the entity obtains a waiver from the lender, but the waiver is for only three months after the reporting period. Paragraph 75 of IAS 1 states that '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

15. In reaching its conclusion, the Committee noted that the entity's expectation in each of the three fact patterns that it will meet the condition tested after the reporting period does not affect its assessment of paragraph 69(d) of IAS 1. Applying paragraphs 69(d) and 72A of IAS 1, the entity's right to defer settlement of a liability for at least twelve months after the reporting period must exist at the end of the reporting period.

Comments on the tentative agenda decision

The Committee's technical analysis and conclusions

16. The Committee discussed the comments it received on the tentative agenda decision at its meeting in April 2021. Most respondents agreed (or did not disagree) with the Committee's technical analysis of all cases discussed—ie applying the amendments to the three fact patterns, the entity classifies the liability as current at the end of the reporting period.

17. Some respondents disagreed with the Committee's technical analysis in at least one of the cases—in their view:

    (a) paragraph 72A of IAS 1 may be read as applying only to conditions required at the end of the reporting period but tested at a later date; and

    (b) it is unclear whether the explanation in paragraph BC48E of IAS 1 (reproduced in Appendix A to this paper) is relevant in assessing compliance with conditions based on an entity's financial position.

18. Having considered respondents' comments, all 14 Committee members confirmed their agreement with the technical analysis and conclusion in the tentative agenda decision (set out in paragraphs 14–15 above).[4]

The outcomes of applying the 2020 amendments

19. Although most respondents agreed (or did not disagree) with the technical analysis, almost all respondents expressed concerns about the outcomes of applying the amendments.

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at least twelve months after the reporting period'. Therefore, the entity would also classify the liability as current applying that paragraph.

[4] Please refer to Agenda Paper 3 for the Committee's April meeting for further information.

20. Most respondents said the outcomes of applying the amendments do not faithfully represent the entity's financial position at the reporting date, particularly in Cases 2 and 3. They said the amendments therefore do not provide users of financial statements with useful information—in their view, the outcomes do not reflect:

    (a) the contractual rights and obligations of the parties; or

    (b) the intention behind the contract and its design.

21. Some respondents also expressed concerns about potential consequences and practical challenges of applying the amendments and commented on other aspects of the amendments.

22. Most respondents suggested that the Committee not finalise the agenda decision but instead refer the matter to the Board. Some suggested that the Board reconsider the amendments before they become effective.

The Committee's decision not to finalise the tentative agenda decision

23. The Board issued the 2020 amendments after undertaking research and public consultation over several years. The Committee noted that some respondents to the tentative agenda decision made comments similar to those already considered by the Board during the development of the amendments. In particular, the Board had considered comments from stakeholders that suggested a current/non-current classification model based:

    (a) on management's expectations about the entity's compliance with conditions to be tested after the reporting period; or

    (b) only on conditions tested on or before the end of the reporting period.

24. The Committee also noted that some of the comments respondents raised might provide information that the Board had not specifically considered when developing the 2020 amendments, in particular comments about:

    (a) conditions designed to incorporate the effects of seasonality, business growth or restructuring; and

    (b) the information provided by classification as current or non-current.

25. Appendix B to this paper includes the analysis the Committee considered in determining whether respondents' comments provide (or do not provide) new information to the Board.

26. After considering respondents' comments—and that some of these comments may provide new information to the Board—the Committee decided that, before it finalises the agenda decision, it would report to the Board:

    (a) its technical analysis and conclusions; and

    (b) respondents' comments on the outcomes and potential consequences of applying the amendments, highlighting those that might provide information the Board did not consider when developing the amendments.

27. Agenda Paper 12C for this meeting includes a summary of feedback on the outcomes and potential consequences of applying the amendments, together with our analysis of that feedback.

Question to the Board
Does the Board have any questions or comments on the background information set out in this paper?

Appendix A—Excerpts from IAS 1 as amended in January 2020

A1. We have reproduced excerpts from IAS 1 below. For convenience, the amendments issued in January 2020 are shown in marked-up text (new text is underlined and deleted text is struck through).

69 An entity shall classify a liability as current when:

(a) it expects to settle the liability in its normal operating cycle;

(b) it holds the liability primarily for the purpose of trading;

(c) the liability is due to be settled within twelve months after the reporting period; or

(d) it does not have ~~an unconditional~~ <u>the</u> right <u>at the end of the reporting period</u> 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~~.

An entity shall classify all other liabilities as non-current.

…

<u>72A</u> <u>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 conditions at the end of the reporting period even if the lender does not test compliance until a later date.</u>

73 If an entity ~~expects, and~~ has the ~~discretion,~~ <u>right, at the end of the reporting period,</u> to ~~refinance or~~ roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. ~~However, when refinancing or rolling over the obligation is not at the discretion~~

~~of the entity (for example, there is no arrangement for refinancing)~~ If the entity has no such right, the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

74 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 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~~ the right to defer its settlement for at least twelve months after that date.

75 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.

A2. We have reproduced paragraphs BC48B, BC48D and BC48E of the Basis for Conclusions on IAS 1 below.

BC48B The Board added to the classification principle in paragraph 69(d) and the example in paragraph 73 clarification that an entity's right to defer settlement must exist 'at the end of the reporting period'. The need for the right to exist at the end of the reporting period was already illustrated in the examples in paragraphs 74 and 75 but was not stated explicitly in the classification principle. …

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.

BC48E The Board considered whether to specify how management assesses an entity's compliance with a condition relating to the entity's cumulative financial performance (for example, profit) for a period extending beyond the reporting period. The Board concluded that comparing the entity's actual performance up to the end of the reporting period with the performance required over a longer period would not provide useful information—one of these measures would have to be adjusted to make the two comparable. However, the Board decided not to specify a method of adjustment because any single method could be inappropriate in some situations.

Appendix B—Analysis of whether comments provide new information

This Appendix reproduces the analysis included in Agenda Paper 3 for the April 2021 Committee meeting.

Comments the Board considered

B1. Some respondents to the draft amendments included in Exposure Draft *Classification of Liabilities* published in February 2015 made comments similar to some of those made by respondents to the tentative agenda decision. In particular, the Board considered comments from stakeholders that suggested a current/non-current classification model based:

(a) on management's expectations about the entity's compliance with conditions to be tested after the reporting period (see paragraphs B2–B4); or

(b) only on conditions that are tested on or before the end of the reporting period (see paragraphs B5–B7).

Management's expectations

B2. In developing the amendments, the Board specifically discussed whether management's expectations should affect classification of a liability as current or non-current. The Board decided against such a model because, among other reasons, it would place too much emphasis on management's intentions and expectations.[5]

B3. A majority of respondents to the Exposure Draft agreed with the Board's approach. During redeliberations, the Board considered comments from respondents who suggested management's expectations be taken into account in determining classification, but the Board nonetheless confirmed its proposed approach.[6] In other words, the Board specifically decided that an entity's rights at the reporting date, rather than management's intentions or expectations, should determine whether the entity classifies a liability as current or non-current. Paragraph BC48C states (emphasis added) 'the Board added paragraph 75A, which explicitly clarifies that

[5] See paragraph BC16 of the Exposure Draft.

[6] See paragraphs 36–40 of Agenda Paper 12B for the Board December 2015 meeting.

classification is unaffected by management intentions or expectations, or by settlement of the liability within twelve months after the reporting period'.

B4. In developing the amendments, the Board therefore considered views similar to some of those expressed by respondents to the tentative agenda decision about the effect on classification of management's expectations.

Conditions tested on or before the end of the reporting period

B5. During redeliberations of the draft amendments, the Board considered comments from stakeholders that questioned whether conditions to be tested only after the reporting period should affect whether an entity has the right to defer settlement. Similar to some respondents to the tentative agenda decision, some stakeholders suggested that such conditions should not affect classification at the reporting date because they could be breached only at a future date (that is, at the reporting date the entity is in compliance with the conditions required at that date).[7]

B6. The Board considered these comments but nonetheless decided to require an entity to test compliance at the reporting date with specified conditions that could affect the right to defer settlement, even if the condition will be tested only after the reporting period.[8] The Board noted that this conclusion was consistent with views that it had included in paragraph BC4 of the Exposure Draft and decided to add it as a requirement to IAS 1 (this requirement was added as paragraph 72A of IAS 1). Paragraph BC4 of the Exposure Draft stated:

> The Board considered a number of examples of conditions that could be placed on exercising a right. The Board concluded that when a right is subject to a condition, it is whether the entity complies with that condition as at the end of the reporting period that determines whether the right should affect classification.

B7. In developing the amendments, the Board therefore considered views similar to some of those expressed by respondents to the tentative agenda decision about the effect on classification of conditions tested after the reporting period.

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[7] See paragraph 17(b) of Agenda Paper 12B for the Board February 2016 meeting.

[8] See IASB update for the Board February 2016 meeting.

Comments that might provide new information

B8. Some of the comments raised by respondents to the tentative agenda decision might provide new information that the Board had not considered when developing the amendments, in particular comments about:

(a) conditions designed to incorporate the effects of seasonality, business growth or restructuring (see paragraphs B9–B10); and

(b) the information provided by classification as current or non-current (see paragraphs B12–B15).

Conditions designed to incorporate the effects of seasonality, business growth or restructuring

B9. As explained in paragraph B5, during redeliberations of the draft amendments, the Board considered how an entity assesses conditions that are tested after the reporting period. In reaching its decisions, the Board considered the staff view at that time that, in general:

(a) the objective of conditions tested after the reporting period is to protect the lender's interests and that, for the condition to be effective in doing so, the protection must be in place continuously; and

(b) the right to defer settlement is implicitly conditional on complying with the conditions specified by the lender, even if those conditions are tested only on a specified date or dates.[9]

B10. The Board concluded that an entity should not ignore conditions to be tested after the reporting period when its right to defer settlement is subject to those conditions but, instead, determine whether it is in compliance with those conditions at the reporting date. As explained at the December 2020 Committee meeting, Board members view the requirements in paragraph 72A as an objective and relatively simple way of assessing an entity's compliance with conditions to be tested after the reporting period.

B11. Feedback on the tentative agenda decision nonetheless provides information about covenants specifically designed to incorporate, for example, the expected effects of

[9] See paragraphs 18–25 of Agenda Paper 12B for the Board February 2016 meeting.

seasonality, business growth or restructuring. In developing the amendments, the Board did not specifically consider such covenants. This feedback may therefore provide new information about particular loan agreements that the Board had not considered.

Information provided by classification as current or non-current

B12. The amendments resulted from a narrow-scope project that retained the principle in paragraph 69(d) regarding classification, but clarified its application in order to reconcile apparent contractions 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.

B13. The classification requirements in IAS 1 necessarily require an entity to classify liabilities as either current or non-current (that is, the classification is binary). These requirements must be able to be applied consistently to all liabilities, irrespective of their terms and conditions which can vary widely.

B14. We think feedback on the tentative agenda decision indicates that, irrespective of the basis for assessing whether an entity has the right to defer settlement, the information provided by a binary classification of liabilities as current or non-current, alone, might be insufficient to allow an understanding of an entity's financial position when an entity's right to defer settlement is subject to compliance with specified conditions after the reporting period.

B15. The Board might wish to consider whether entities should be required to provide further information about such conditions and their effect on an entity's exposure to liquidity risk, in addition to the disclosures already required by IFRS 7 *Financial Instruments: Disclosures*.