

More debt could be classified as current

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Classifying debt – Does hypothetical testing at the reporting date give the right outcome?

Highlights

- Classifying loans with future conditions using a hypothetical test
- Potential mismatch between the accounting and the loan's terms and conditions
- No remedies might be available for a breach of a hypothetical test
- Classification of loans with financial performance or qualitative covenants remains unclear
- Have your say – Comment deadline is 15 February 2021.

Companies could see significant changes when classifying loans as current or non-current.

Under the International Accounting Standards Board's (the Board) **amendments to IAS 1**¹ which become effective in 2023, companies will need to consider the impacts of these amendments and revisit their loan agreements, as more debt could be classified as current.

In its recent **tentative agenda decision** (TAD)², the IFRS Interpretations Committee (the Committee) clarified that classifying debt with future conditions as current or non-current would be based on a *hypothetical test* at the reporting date – a test that the lender does not require until a later date. The TAD illustrates how a company would apply the amendments using three different **term loan examples**.

Classifying loans with future conditions using a hypothetical test

The TAD clarifies that when the right to defer settlement of a liability for at least 12 months after the reporting date is subject to future conditions related to financial position, a company (borrower) would need to perform a hypothetical test for compliance at the reporting date:

- if the loan agreement requires the test for compliance at a later date; and
- using its financial information as at the reporting date.

1. *Classification of Liabilities as Current or Non-current (Amendments to IAS 1 Presentation of Financial Statements).*
2. *Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements).*

This means that a company would classify its debt as non-current only when it complies at the reporting date with *all* conditions – i.e. those conditions that exist at the reporting date and those that are due to be tested within 12 months after that date.

Potential mismatch between the accounting and the loan's terms and conditions

The use of a hypothetical test means that how debt is classified for accounting purposes at the reporting date may not reflect the contractual rights and obligations of the contracted parties. For example, a loan that is not due for settlement within 12 months after the reporting date could be classified as current even though:

- the lender does not have the contractual right to demand repayment; and
- the borrower does not have the contractual obligation to settle it at the reporting date.

Therefore, to classify a loan as non-current for accounting purposes, a company would need to comply with the conditions specified in the loan agreement at all times, even if the loan agreement was negotiated to cater for a company's specific circumstances. For example, a specific loan agreement may consider seasonality of the business or different stages of a company's operations and thus require compliance with different conditions on different dates.

In practice, this would also mean that a loan's classification may change from one reporting date to another, including from one interim reporting date to another, without any actual breach of its contractual conditions.

No remedies might be available for a breach of a hypothetical test

A company that 'breaches' a hypothetical test would need to classify the loan as current – i.e. it has no remedy. This is because a lender typically provides a waiver only for an actual breach of the loan conditions that occurs prior to or at the reporting date.

Classification of loans with financial performance or qualitative covenants remains unclear

The TAD illustrates only loans with covenants that test financial position and is limited to the three fact patterns described. The TAD does not clarify if/how classification of a loan with a financial performance condition (e.g. annual revenue target to be tested after the reporting date) or with qualitative covenants (e.g. submission of audited financial statements of the borrower by a certain date) would be affected by the forthcoming amendments.

Have your say – Comment deadline is 15 February 2021

The amendments would cause a significant change in practice. More debt would be classified as current even when a company does not have the contractual obligation to repay a liability within 12 months after the reporting date.

We urge you to take this opportunity to give your feedback to the Committee on the TAD via the following [link](#).

Three examples of term loans

The IFRS Interpretations Committee considered the following three examples of term loans in its tentative agenda decision (TAD).

All three cases consider the classification of a five-year term loan, fully drawn down and with a due date of 31 December 20X6.

	Case 1	Case 2	Case 3	
Condition – working capital (WC) ratio	Above 1.0	Above 1.0	Above 1.0	Above 1.1
Testing dates	Each 31 Dec, 31 Mar, 30 Jun, and 30 Sept	Each 31 Mar	31 Dec 20X1	30 Jun 20X2 and each 30 Jun thereafter
Compliance with conditions at 31 Dec 20X1 (i.e. both those conditions at the reporting date and thereafter)	<p>WC ratio is 0.9</p> <p>The company obtains a waiver for the breach before 31 Dec 20X1. The waiver is for three months only</p> <p>The company expects the WC ratio to be above 1.0 at 31 Mar 20X2 (and the other testing dates in 20X2)</p>	<p>WC ratio is 0.9</p> <p>The company expects the WC ratio to be above 1.0 at 31 Mar 20X2</p>	WC ratio is 1.05	
Classification of the loan at 31 Dec 20X1 using rationale in TAD	<ul style="list-style-type: none"> – Current liability – Actual breach of the condition at the reporting date (31 Dec 20X1) – i.e. the company does not comply with the condition at the reporting date but obtains a waiver for that breach prior to that date – The waiver covers only three months so at the reporting date, the company does not have the right to defer settlement for at least 12 months after that date 	<ul style="list-style-type: none"> – Current liability – The company assesses if it complies with the future condition at the reporting date (31 Dec 20X1) even though the test is not contractually required until 31 Mar 20X2 – i.e. the company must perform a hypothetical compliance test at the reporting date even though the loan agreement requires testing for compliance only at a later date – As the working capital ratio is 0.9 at 31 Dec 20X1, the company fails the <i>hypothetical</i> compliance test – i.e. it does not have the right to defer settlement for at least 12 months after the reporting date 	<ul style="list-style-type: none"> – Current liability – The company assesses if it complies with the conditions at the reporting date (31 Dec 20X1). However, the company must also perform a hypothetical test for compliance with the condition at future dates within 12 months after the reporting date (i.e. 30 Jun 20X2) – Even though the company complies with the condition at the reporting date (i.e. the actual compliance test at 31 December 20X1 per the loan agreement), it fails the <i>hypothetical</i> compliance test with the future condition set for Jun 20X2 – i.e. it does not have the right to defer settlement for at least 12 months after the reporting date 	
Future expectations	It is irrelevant that the company expects the working capital ratio to be above 1.0 at 31 Mar 20X2 (and the other testing dates in 20X2) or may expect to receive another waiver from the lender	It is irrelevant that the company expects the working capital ratio to be above 1.0 at 31 Mar 20X2	It is irrelevant that the company expects the working capital ratio to be above 1.1 at 30 Jun 20X2	

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