KPMG

Classifying liabilities as current or non-current

Global IFRS Institute

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"We welcome the final amendments on classifying liabilities, particularly the removal of the so-called 'hypothetical' covenant test. Companies need to revisit their loan arrangements now to determine whether the classification of their liabilities (e.g. convertible debt) will change, and prepare to provide new disclosures about certain covenants."

Gabriela Kegalj
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IAS 1 amendments effective January 2024

Highlights

- Right to defer settlement must exist at reporting date and have substance
- Liabilities with covenants – Classification criteria clarified and new disclosures
- Convertible debt may become current
- Effective date – Applies retrospectively from January 2024

Under the amendments to IAS 1 *Presentation of Financial Statements* the classification of certain liabilities as current or non-current may change (e.g. convertible debt). In addition, companies may need to provide new disclosures for liabilities subject to covenants.

The amendments will apply from 1 January 2024. However, companies need to consider whether their upcoming annual financial statements will need to include disclosures under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* of the possible future impacts.

Right to defer settlement must exist at reporting date and have substance

Under existing IAS 1 requirements, companies classify a liability as current when they do not have an *unconditional right* to defer settlement for at least 12 months after the reporting date. The International Accounting Standards Board (IASB) has removed the requirement for a right to be unconditional and instead now requires that a right to defer settlement must exist at the reporting date and have substance.

Similar to existing requirements in IAS 1, the classification of liabilities is unaffected by management's intentions or expectations about whether the company will exercise its right to defer settlement or will choose to settle early.

Liabilities with covenants – Classification criteria clarified and new disclosures

A company will classify a liability as non-current if it has a right to defer settlement for at least 12 months after the reporting date. This right may be subject to a company complying with conditions (covenants) specified in a loan arrangement.

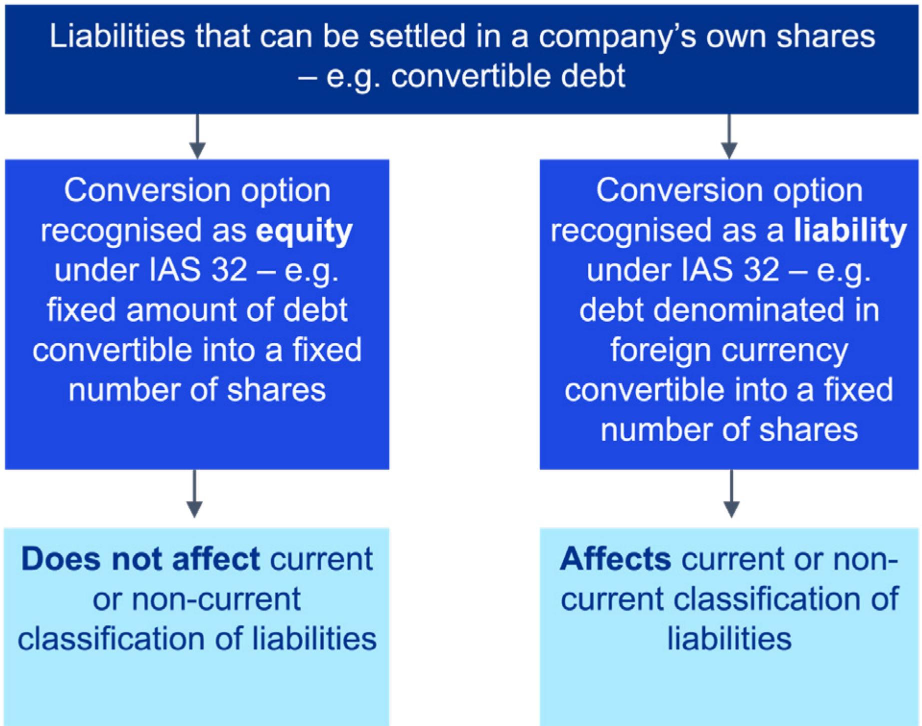
After reconsidering certain aspects of the 2020 amendments[1], the IASB reconfirmed that only covenants with which a company must comply *on or before* the reporting date affect the classification of a liability as current or non-current.

Covenants with which the company must comply *after* the reporting date (i.e. future covenants) do not affect a liability's classification at that date. However, when non-current liabilities are subject to future covenants, companies will now need to disclose information to help users understand the risk that those liabilities could become repayable within 12 months after the reporting date. See **Example 1**.

Convertible debt may become current

The amendments also clarify how a company classifies a liability that can be settled in its own shares – e.g. convertible debt.

When a liability includes a counterparty conversion option that involves a transfer of the company's own equity instruments, the conversion option is recognised as either equity or a liability separately from the host liability under IAS 32 *Financial Instruments: Presentation*. The IASB has now clarified that when a company classifies the host liability as current or non-current, it can ignore only those conversion options that are recognised as equity.



Companies may have interpreted the existing IAS 1 requirements differently when classifying convertible debt. Therefore, convertible debt may become current (see **Example 2**).

Effective date – Applies retrospectively from January 2024

The amendments apply retrospectively for annual reporting periods beginning on or after 1 January 2024, with early application permitted. They also specify the transition requirements for companies that may have early-adopted the previously issued but not yet effective 2020 amendments.

1 Classification of Liabilities as Current or Non-current (Amendments to IAS 1), published in January 2020

Example 1

Loan subject to covenants

- A company has a loan that is repayable in five years.
- The loan includes a covenant requiring a working capital (WC) ratio of at least 1.2 on 31 December 2024 and 1.5 on 30 June 2025. The loan becomes repayable on demand if the ratio is not met on any of the specified covenant testing dates.
- The company is preparing its annual financial statements for the year ending 31 December 2024. The WC ratio at 31 December 2024 is 1.3 and the company expects the ratio to be 1.4 at 30 June 2025.

	Loan covenant	Impacts classification at 31 December 2024?
Reporting date	WC ratio of at least 1.2 (tested at 31 December 2024)	**Yes.** Because the company complies with the covenant at the reporting date, it will classify the loan as **non-current.**
Future covenant	WC ratio of at least 1.5 (tested at 30 June 2025)	**No.** Covenants that the company must comply with after the reporting date do not affect the classification of the loan at the reporting date. However, new **disclosures** will apply.
Future expectation	Expected WC ratio of 1.4 at 30 June 2025	**No.** Management's expectation of compliance with the future covenant is irrelevant for classification purposes, but new **disclosures** will apply.

Example 2

Foreign currency convertible bond

- A foreign currency convertible bond will mature on 31 December 2027.
- The bond comprises a financial liability and an option granted to the holder to convert the bond into a fixed number of the company's ordinary shares at any time before maturity.
- The conversion option does not meet the definition of an equity instrument because it fails the 'fixed-for-fixed' criteria and is an embedded derivative recognised separately from the host liability.

Assessment at 31 December 2024 (the reporting date)

Classification under existing requirements	Classification after the amendments
Mixed practice Current IAS 1* is unclear.	**Current** The transfer of the company's own equity instruments is a form of settlement. As the holder has an option to convert the host liability into the company's own equity instruments at any time before maturity, the company does not have the right to defer settlement for at least twelve months from the reporting date. Therefore, the host liability is classified as current.

*IAS 1 *Presentation of Financial Statements*

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