CLASSIFICATION OF LIABILITIES AS CURRENT OR NON-CURRENT: FAQs

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BACKGROUND

IAS 1 *Presentation of Financial Statements* requires entities that prepare a classified statement of financial position to present liabilities as either current or non-current.

IAS 1.69 requires a liability to be classified as current if any one of the following four criteria are met:

(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 right 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.*

If any of these criteria are met, the liability must be classified as current.

ACCOUNTING IMPACT

The financial effects of COVID-19 may cause entities to breach contractual requirements, such as covenants, in lending agreements. This may result in liabilities, including bank borrowings, being classified as current liabilities in the related statement of financial position.

This classification will affect key gearing ratios and financial metrics used by users of financial statement.

COVID-19 has resulted in significant financial difficulties for many entities, including significant liquidity constraints. These effects have highlighted the importance of classifying liabilities correctly, as doing so provides users with important information about liabilities that will or may require settlement in the next 12 months.

This publication explains the requirements of IAS 1.69 through frequently asked questions (FAQs), which BDO has encountered commonly in practice.

It should be noted that the IASB amended these requirements in January 2020, which will be mandatorily effective for annual reporting periods beginning on or after 1 January 2023. These amendments are detailed in IFRB 2020/01 (available here). This publication addresses the current requirements in IAS 1. The conclusions in this publication may change under the revised requirements.

SCOPE OF THE CLASSIFICATION REQUIREMENTS

FAQ 1.1: which liabilities do the classification requirements of IAS 1.69 apply to?

The requirements of IAS 1.69 apply to all types of liabilities (e.g. bank borrowings, corporate bonds, lease liabilities, contract liabilities and accounts payable) except for deferred tax liabilities, which are always presented as non-current (IAS 1.56).

The only exception to this requirement is when a presentation based on liquidity provides information that is more reliable and more relevant (i.e. a ‘non-classified’ statement of financial position – IAS 1.60). Such a presentation is common for financial institutions such as banks and insurance companies. In these cases, a distinction between current and non-current assets and liabilities is not made in the statement of financial position.

‘SPLIT’ PRESENTATION

FAQ 2.1: are liabilities divided into current and non-current portions?

If a portion of a liability does not meet any of the criteria in IAS 1.69, then that portion of the liability is presented as non-current.

For example, many bank loans and lease liabilities are amortising, with regular payments of principal and interest. Those payments that are contractually due within the next 12 months result in IAS 1.69(d) being met as the entity does not have an unconditional right to defer settlement of those portions of the liability for at least 12 months. Therefore, those payments are classified as current.

As long as the remaining portion (or portions) do not meet any of the criteria in IAS 1.69, the payments due more than 12 months after the reporting period are classified as non-current liabilities.

EFFECT OF COVENANTS ON CLASSIFICATION – GENERAL MATTERS

FAQ 3.1: Entity Z has a 31 December 2020 year-end. Entity Z has a term loan with a bank, which requires it to repay the entire capital balance on 31 December 2024. Included in the loan agreement is a covenant requiring Entity Z to maintain a specified financial ratio as at each year-end. If Entity Z does not satisfy the covenant, then the bank has the right to demand that Entity Z repay the loan immediately.

Entity Z has met the specified financial ratio as at 31 December 2020. How does Entity Z classify the capital element of the bank loan in its 31 December 2020 financial statements?

IAS 1.69(d) is not met because Entity Z has an unconditional right to defer settlement of the liability for at least 12 months because it satisfies the covenant in the loan and therefore the bank does not have the right to demand repayment of the loan in the next 12 months. None of the other criteria in IAS 1.69 are met.

The capital amount of the bank loan is classified as a non-current liability.

FAQ 3.2: Same fact pattern as FAQ 3.1 except Entity Z does not meet the covenant as at 31 December 2020, however, on 15 February 2021, before the financial statements are authorised for issue by the Board of Directors, Entity Z receives a waiver of the covenant violation from its bank. Therefore, the bank has stated that it will not demand repayment of the loan in 2021.

How does Entity Z classify the bank loan in its 31 December 2020 financial statements?

IAS 1.69(d) is met because Entity Z does not have an unconditional right to defer settlement of the liability for at least 12 months as at its reporting date of 31 December 2020. IAS 1.74 requires that:

> *When an entity breaches a provision 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 right to defer its settlement for at least twelve months after that date.*

The bank granting the waiver is a non-adjusting event after the reporting period. It does not affect the classification of the bank loan as at 31 December 2020. This requirement differs from certain other financial reporting frameworks (e.g. US GAAP), where receipt of a waiver of a covenant violation after period end may affect the classification of the liability as at the reporting date.

Entity Z may be required to disclose the waiver as a non-adjusting event after the reporting period in accordance with IAS 10.21.

FAQ 3.3: Same fact pattern as FAQ 3.1 except Entity Z is concerned that it will not meet its financial covenant as at 31 December 2020, so it discusses the matter with its bank in November 2020. On 15 December 2020, the bank agrees to waive the covenant as at 31 December 2020, meaning Entity Z does not need to comply with the covenant as at 31 December 2020. Entity Z needs to comply with the covenant as at future reporting dates (in this fact pattern, the next covenant test will be on 31 December 2021).

How does Entity Z classify the bank loan in its 31 December 2020 financial statements?

IAS 1.69(d) is not met because, as at its reporting date, Entity Z has an unconditional right to defer settlement of the liability for at least 12 months. The waiver was received prior to the period end, meaning that it is taken into account in assessing whether any of the criteria in IAS 1.69 were met. IAS 1.75 requires (continuing on from IAS 1.74, see FAQ 3.2):

> *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.*

The capital amount of the bank loan is therefore classified as a non-current liability.

FAQ 3.4: Same fact pattern as FAQ 3.1 except the banking agreement states that the covenants will be tested based on the audited financial statements once they are approved and released. Entity Z expects to issue its audited financial statements for the period ended 31 December 2020 by 1 March 2021. Entity Z violates its financial covenant as at 31 December 2020 based on its audited financial statements.

Since the audited financial statements were not available as at 31 December 2020, is the breach of covenant a non-adjusting event after the reporting period, meaning that it does not affect the classification of the loan as current or non-current?

No. The loan is required to be classified as current regardless of the fact that the audited financial statements were not yet available, as the conditions that led to the breach already existed at the reporting date. The audited financial statements provide evidence of that breach.

EFFECT OF COVENANTS ON CLASSIFICATION – QUARTERLY TESTING

FAQ 3.5: Entity Y has a 31 December 2020 year-end. Entity Y has a term loan from a bank, which requires it to repay the entire capital balance on 31 December 2024. Included in the loan agreement is a covenant requiring Entity Y to maintain a specified financial ratio as at each quarter end (e.g. March, June, September and December). If Entity Y does not satisfy the covenant at any of these dates, then the bank has the right to demand that Entity Y repay the loan immediately.

Entity Y has met the specified financial ratio as at 31 December 2020. How does Entity Y classify the bank loan in its 31 December 2020 financial statements?

The criterion in IAS 1.69(d) is not met because Entity Z has an unconditional right to defer settlement of the liability for at least 12 months because it satisfies the covenant in the loan at its reporting date. Therefore, as at that date, the bank does not have the right to demand repayment of the loan in the next 12 months.

The fact that compliance with the covenant will be tested again in less than 12 months (e.g. 31 March 2021) does not change the fact that, as at its reporting date, Entity Y complies with the covenant. The subsequent covenant tests are based on the financial ratios at those future dates, which do not affect conditions as at 31 December 2020.

The bank loan is classified as a non-current liability.

FAQ 3.6: Same fact pattern as FAQ 3.5, except it is currently 5 April 2021 and the 31 December 2020 financial statements have not been completed. Entity Y met its loan covenant as at 31 December 2020, but Entity Y has violated its covenant as at 31 March 2021.

How does Entity Y classify the bank loan in its 31 December 2020 financial statements?

The criterion in IAS 1.69(d) is not met because Entity Z has an unconditional right to defer settlement of the liability for at least 12 months because it satisfies the covenant in the loan at its reporting date. Therefore the bank does not have the right to demand repayment of the loan in the next 12 months.

The fact that compliance with the covenant will be tested again in less than 12 months (e.g. 31 March 2021) does not change the fact that, as at its reporting date, Entity Y complies with the covenant. The subsequent breach of covenant as at 31 March 2021 does not affect conditions as at 31 December 2020.

The bank loan is classified as a non-current liability. Failure to comply with the covenant as at 31 March 2021 should be disclosed as a non-adjusting subsequent event in the 31 December 2020 financial statements (IAS 10.21).

ROLLOVERS AND MODIFICATIONS TO EXISTING LOANS

FAQ 4.1: Entity M has a loan that is due for repayment within 12 months of the reporting period end. The terms of the loan grant Entity M the option to roll over the loan for another 12 months, with the rollover being conditional on Entity M passing a financial test.

How is the loan classified as at Entity M's period end if the rollover has not taken place?

The classification depends on the precise facts and circumstances. IAS 1.73 states that if an entity expects, and has the discretion, to refinance or roll over an obligation for at least 12 months after the reporting period under an existing loan facility, then it is classified as non-current. An entity must assess whether it has the 'discretion' to do so. For example, discretion in respect of a financial ratio test would include consideration of whether the entity expects to pass that test. This would include circumstances in which an entity would not currently pass the test, but could take action to enable it to do so by the time the test is required to be carried out.

Consequently, the loan is classified as non-current if the rollover conditions are perfunctory and/or are within Entity M's control (e.g. not to sell a subsidiary or to enter into other loan agreements) and management expects to exercise the option to roll over the loan.

The loan is classified as current if management does not intend to roll over the loan. The loan will also be classified as current if the rollover condition(s) have been breached and management can do nothing to rectify the position (e.g. a covenant which requires that a particular subsidiary is not sold, and the subsidiary has already been sold by the financial period end).

FAQ 4.2: Entity N will be required to repay a bank loan within 12 months of period end. Before period end, Entity N enters into an agreement with a new bank where the new bank will 'roll' the old loan into a new loan, which will not be repayable for another 5 years.

How is the loan classified as at period end?

The loan is classified as a current liability. Entity N has an obligation to settle the amount due under its existing loan with the original bank within the next 12 months, regardless of the fact that it entered into an agreement with another bank which ensures that it will have the necessary funds to repay the original loan.

If Entity N had entered into an agreement before period end to roll the loan into a new loan with the original bank, then FAQ 4.1 would apply, and the loan would be classified as current or non-current depending on whether Entity N has the intention and discretion to roll over the existing loan.

CLASSIFICATION OF CONTRACT LIABILITIES

FAQ 5.1: Entity X sells clothing and, with each purchase, customers may earn loyalty points which can be accumulated and redeemed in future for free or discounted merchandise. Each point entitles the customer to a CU 0.10 discount on a future purchase, which may be redeemed at any time by the customer. When a sale is made, Entity X allocates a portion of the transaction price to each of the points, and recognises them as a contract liability as required by IFRS 15.

Entity X has historical data which provides strong support that only 50-55% of the points earned in a given calendar year will be redeemed during the following calendar year. This is because many customers prefer to accumulate their points for a larger purchase.

How does Entity X classify its contract liability relating to the points?

All points are classified as current liabilities because Entity X does not have an unconditional right to defer settlement of the related contract liability for at least 12 months.

Technically, every customer could decide to redeem all of their points within the next 12 months. It is not relevant that Entity X has strong historical evidence that this will not take place, as IAS 1.69(d) is based on the contractual rights and obligations of Entity X and its customers.

CLASSIFICATION OF TRADE PAYABLE

FAQ 6.1: is a trade payable due to be paid more than 12 months after the reporting period classified as a current or non-current liability?

IAS 1.70 states that some liabilities, including trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. Therefore, such liabilities are classified as current even if they are due to be settled more than 12 months after the reporting period. This is because the criterion in IAS 1.69(a) is met as the entity 'expects to settle the liability in its normal operating cycle'. If an entity's normal operating cycle is not clearly identifiable, IAS 1.70 requires an entity to assume that is 12 months.

CLASSIFICATION OF CONVERTIBLE NOTES

FAQ 7.1: Entity A issues a CU1,000 convertible note in return for the same amount of cash consideration. The note has a maturity of three years from its date of issue. The note pays a 10% annual coupon in arrears, and, on maturity, the holder has an option either to receive a cash repayment of CU1,000 or 10,000 of the issuer's shares (i.e. the conversion feature is a European-style option exercisable only upon maturity). The market interest rate for a note without a conversion feature would have been 12% at the date of issue.

Entity A accounts for the convertible note in accordance with IAS 32 as a compound financial instrument. Entity A recognises a financial liability at the present value of the cash flows using a 12% discount rate, with conversion feature being classified as an equity instrument as it is a derivative that satisfies IAS 32's 'fixed for fixed' test.

How is the liability component classified at the date on which the convertible note is issued?

The liability component is classified as non-current as Entity A has the unconditional right to defer settlement of the liability for three years.

FAQ 7.2: Same fact pattern as FAQ 7.1, except the conversion feature may be exercised at any time by the holder (i.e. the conversion feature is an American-style option exercisable at any time). Any accrued interest prior to the conversion feature being exercised must be paid by Entity A.

Entity A accounts for the convertible note in the same way as in FAQ 7.1. This is because the conversion feature still satisfies the 'fixed for fixed' test as it results in a fixed amount of cash (the outstanding principal amount of the loan) being converted into a fixed number of shares.

How is the liability component classified?

The liability component is classified as non-current. The holder of the convertible note has the option to settle the liability at any time by exercising the conversion feature, however, IAS 1.69(d) states *'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.'*

Therefore, while the conversion feature may result in the liability being settled at any time in the next three years, it does not result in current classification because it will only result in the liability being settled by the issue of equity instruments. The effect of the conversion feature on the classification of the liability is ignored.

FAQ 7.3: Same fact pattern as FAQ 7.2, except that the coupon 'rolls up' and is added to the amount repayable on maturity of the loan. However, at any point, the carrying amount of the liability (i.e. unpaid principal and interest) will convert into 10,000 of Entity A's shares.

Entity A classifies the convertible note as a hybrid financial instrument. The convertible note contains both a financial liability relating to the obligation to pay cash (i.e. principal and interest) and a derivative financial instrument relating to the conversion feature. The conversion feature is not classified as equity because it fails the 'fixed for fixed' test. This is because exercising the conversion feature will result in a variable amount of cash (unpaid principal plus accrued interest, which will vary over the term of the note) being converted into a fixed number of shares. The conversion feature introduces the possibility that the loan may be settled by the exchange of a variable amount of an obligation to pay cash for a fixed number of shares, which is not an equity instrument.

How are the liabilities classified?

Under the current requirements of IAS 1, practice has differed in how the conversion feature affects the classification of the two financial liability components of this hybrid financial instrument.

One approach is to classify both portions as non-current liabilities. This is because IAS 1.69(d) states (***emphasis added***) *'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.'* Some have interpreted this to mean that, because the shares that would be issued upon the holder exercising the conversion feature are equity instruments, this settlement feature does not affect the classification of the convertible note. Therefore, both financial liabilities are classified as non-current.

Another approach is to consider that because the conversion feature is classified as a financial liability as a result of failing the 'fixed for fixed' test in IAS 32, both components of the convertible note should be classified as current liabilities.

Diversity exists in practice under current IAS 1 requirements. It should be noted that the amendments to IAS 1, which are effective for annual reporting periods beginning on or after 1 January 2023 clarify this requirement. Please see IFRB 2020/01 (available here) for further information.