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Classification of liabilities as current or non-current

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Governments around the globe are taking increasingly stringent steps to help contain or delay the spread of the coronavirus (COVID-19). Those steps may result in significant disruptions to your business operations. Like many other companies you may be in negotiations regarding existing or new loans in order to secure sufficient liquidity to pull through the situation. But have you already analyzed the impact of the new requirements in IFRS [1] regarding the balance sheet classification of liabilities as current or non-current? If you are talking to your lenders, you should consider those impacts. Depending on your individual situation, you may not want to wait until 2022 to apply the new requirements and/or to amend loan agreements.

What are the new requirements for classifying a liability as current?
A liability is classified as current when:

- settlement is expected in the normal operating cycle or due within twelve months after the reporting period,
- the liability is primarily held for trading purposes, or
- the company does not have the right at the end of the reporting period to defer settlement for at least twelve months after the reporting period.

Any other liability is classified as non-current.

That sounds familiar. What has changed compared to the existing requirements?
The changes relate to the last criterion (mentioned above) for classifying a liability as current.

Under the existing requirements, the right to defer settlement has to be unconditional. However, such rights are rarely unconditional in practice. Typically, compliance with covenants is required in order to defer settlement. Changing the criterion to "the right to defer settlement must have substance and exist at the end of the reporting period" will therefore result in more liabilities being classified as non-current.

Another change relates to options to settle an existing liability with the borrower's own equity instruments. Under the new requirements, the terms of this conversion option will have an impact on classification. Consequently, this change can result in fewer liabilities being classified as non-current.

Which liabilities will be impacted by the changes?
Impacts are primarily expected for rollover loans and convertible liabilities.

What changes for rollover loans?
A rollover loan is a loan which is renewed when it is not repaid in full within the predefined loan term. Therefore, if the remaining loan term is less than twelve months, the question arises whether such a loan should be classified as current (i.e. no renewal is assumed) or non-current (i.e. renewal is assumed).

The answer depends on the conditions of the right to renew. When the right to renew is subject to compliance with covenants, those need to be met at the end of the reporting period. Compliance at the end of the reporting period is required regardless of whether the lender tests compliance at this or only at a later date.

[1] Amendments to IAS 1: Classification of Liabilities as Current or Non-current.

But what does that mean in practice? Some rollover loans will be reclassified from current to non-current liabilities. Let's illustrate this with the following example:

- Existing rollover loan with a term of three months.
- Automatic renewal every quarter if certain covenants are met at the end of the quarter.
- Covenants are met at the end of the reporting period (31 December 2020).
- Rollover facility has a remaining term of four years, i.e. automatic and consecutive renewals are available until 31 December 2024.

How is this rollover loan classified at 31 December 2020? In this example, there is no unconditional right to defer settlement and, hence, the liability is classified as current under the existing requirements. Applying the new requirements, the loan is generally classified as non-current, because the covenants are met as of the reporting date and settlement can be deferred until 31 December 2024 by way of consecutive renewals.

What happens if covenants are based on cumulative financial performance?

When testing covenant compliance at the end of the reporting period, covenants that are based on cumulative financial performance should be considered carefully. Companies need to make sure that they compare measures for equivalent periods. This may require individual adjustments to the calculations. In the absence of specific guidance, a company applies judgement to make any necessary adjustments.

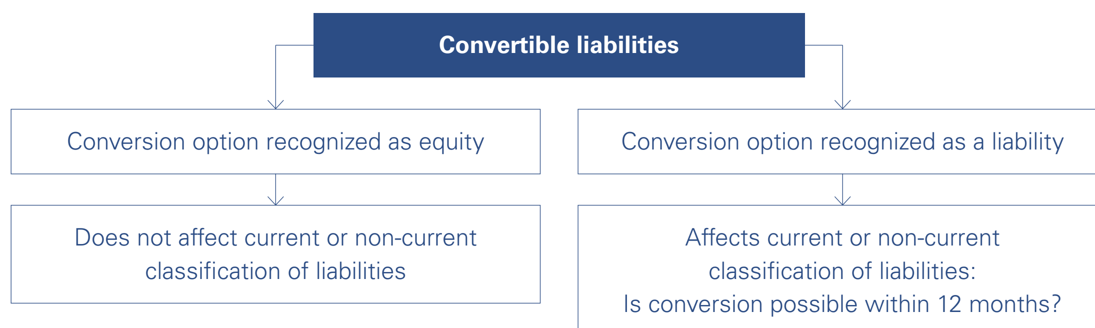
Is management's intention relevant for the classification?

No. Classification of a liability is unaffected by the likelihood that the company will exercise its right to defer settlement for at least twelve months after the reporting period. Therefore, if such a right to defer settlement exists, the liability is always classified as non-current even if settlement is anticipated or actually occurs within twelve months.

What changes for convertible liabilities?

Convertible liabilities are liabilities that at the option of the lender can be settled by either cash or shares[2] of the borrower.

Let's assume that such a liability will be repaid in cash in five years, but the lender can decide at any point in time to forego cash repayment and require immediate settlement in shares. Under the existing requirements, the liability can be classified as non-current. However, based on the new requirements classification as current may be required:



The figure above illustrates that classification of a convertible liability depends on the accounting treatment of the conversion option:

- If the conversion option is recognized as equity, then there is no impact on classification – i.e. the liability in our example is classified as non-current. This outcome is consistent with the existing requirements.
- If the conversion option is recognized as a liability, then there is an impact on classification – i.e. the liability in our example is classified as current. This may represent a change compared to the existing requirements.

But when is a conversion option recognized as equity? A conversion option is recognized as equity if it requires settlement of the loan by delivering a fixed number of shares for a fixed principal amount of the loan ("fixed-for-fixed requirement").

In contrast, the following conversion options are recognized as a liability:

- settlement of the loan for a variable number of shares,
- foreign currency[3] loan that can be settled in shares, or
- settlement of the loan includes the principal amount and the cumulative interest balance for a fixed number of shares.

[2] Or other forms of the borrower's own equity instruments.
[3] Foreign currency means a currency other than the functional currency of the borrower.

Is there any change to the requirements regarding covenant breaches?

No. When a borrower breaches a condition (covenant) of a long-term loan on or before the reporting date with the effect that the loan becomes payable on demand, it classifies the loan as current. An agreement of the lender after the reporting date, but before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach, does not retrospectively change classification to non-current.

When and how should the changes be applied?

The changes are effective for reporting periods beginning on or after 1 January 2022, but can also be applied earlier. Companies are required to apply the changes retrospectively. Consequently, if there is a change in classification, companies will need to change the amounts presented for prior periods as well.

What action shall I take now?

Find out whether your company has liabilities that are affected by the changes. If your company has affected liabilities, the potential impacts should be assessed. This assessment should include a review of existing covenants in order to avoid future surprise.

If you expect an impact on covenant compliance, it is important to consider remediating measures and/or start discussions with lenders early. Why wait until 2022 to discuss amendments to existing loan agreements if you are currently in discussions with your lenders?

Short-term rollover facilities may provide your company with valuable liquidity in the current challenging environment. Due to the uncertainty of the further developments, you may expect to use these funds for a longer period. Do you want to align balance sheet presentation with your expectation? If so, you may want to think about early application of the new requirements.

Contacts

KPMG AG
Räffelstrasse 28
Postfach
CH-8036 Zurich

kpmg.ch

Daniel Haas
Head of Accounting Advisory Services

+41 58 249 33 82
dhaas@kpmg.com

Frank Richter
Head of DPP IFRS

+41 58 249 30 73
frankrichter1@kpmg.com

Petrik Leutert
Senior Manager, Financial Services

+41 58 249 42 07
pleutert@kpmg.com

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