Classification of debt with covenants

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"Companies may welcome the proposed clarifications but the much-debated 'hypothetical test' of compliance would live on in the notes to the financial statements. Companies would also need to provide forward-looking information on whether and how they expect to comply with future covenants – a task likely to involve significant effort and judgement."

Gabriela Kegalj
KPMG global IFRS presentation leader

Clarifications proposed on classifying debt with covenants as current or non-current

Highlights

- **Classification of debt based on compliance with covenants on or before the reporting date**
- **New presentation and disclosures for debt with future covenants**
- **Effective date of previously published IAS 1 amendments deferred**
- **Next steps**

In response to feedback, the Board is proposing to amend IAS 1 *Presentation of Financial Statements* once more to clarify how companies would classify debt with covenants (conditions). These proposals would change the requirements introduced in its **amendments**[1] published in January 2020 (the 2020 amendments) and also defer the effective date of the 2020 amendments for at least one year.

The 2020 amendments aimed to promote consistency in applying IAS 1 and clarify the requirements for classifying debt as current or non-current. However, their application to debt with future covenants raised additional questions, in particular, around the new requirement for a 'hypothetical test' of compliance with future covenants.

Classification of debt based on compliance with covenants on or before the reporting date

The Board's **proposals**[2] change the 2020 amendments to specify 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. In contrast, covenants

1. *Classification of Liabilities as Current or Non-current (Amendments to IAS 1).*
2. *Exposure Draft 2021/9: Non-current Liabilities with Covenants.*

with which the company must comply within twelve months *after* the reporting date (or beyond) would have no effect on the classification of a liability. In other words, covenants to be tested *after* the reporting date would be *ignored* for classification purposes.

Illustrative example

A company has a loan repayable in five years. The loan includes a covenant requiring a working capital (WC) ratio of at least 1.2 on 31 December 2021 and 1.5 on 30 June 2022. The loan becomes repayable on demand if the ratio is not met at any of the specified testing dates.

The company is preparing its annual financial statements for the year ending 31 December 2021. The WC ratio at 31 December 2021 is 1.3 and the company expects the ratio to be 1.4 at 30 June 2022.

Loan covenant		Impacts classification at 31 December 2021?
Reporting date	WC ratio of at least 1.2 (tested at 31 December 2021)	**Yes**. Because the company complies with the covenant at the reporting date, it would classify the loan as **non-current**.
Future covenant	WC ratio of at least 1.5 (tested at 30 June 2022)	**No**. The 'hypothetical test' of compliance (i.e. whether the company would have complied with the future covenant based on conditions at the reporting date) is irrelevant for classification purposes, but new disclosures would apply.
Future expectation	Expected WC ratio of 1.4 at 30 June 2022	**No**. Management's expectations of compliance with the future covenant is irrelevant for classification purposes, but new disclosures would apply.

Additional clarifications

IAS 1 would be amended further to clarify that a company does not have a right to defer settlement, and would therefore classify a liability as current, if the liability could become repayable within twelve months:

- at the discretion of the counterparty or a third party – e.g. when a loan is callable by the lender at any time without cause; or
- depending on an uncertain future event or outcome that is unaffected by the company's future actions – e.g. when the liability is a financial guarantee or insurance contract.

New presentation and disclosures for debt with future covenants

Companies would be required to present a separate line item in the balance sheet for non-current liabilities that are subject to future covenants and provide additional disclosure to enable users of financial statements to assess the risk that the liability could become repayable within twelve months. Disclosures would include:

- information about the covenants – e.g. their nature and the date on which the company must comply with them;
- whether the company would have complied with them at the reporting date; and
- whether and how the company expects to comply with them in the future.

Effective date of previously published IAS 1 amendments deferred

The proposals would amend some of the requirements of the 2020 amendments before those requirements become effective[3]. The Board is therefore proposing to defer the effective date of the 2020 amendments to no earlier than 1 January 2024 (date to be decided after exposure) to avoid companies potentially having to change their assessment of the classification of debt twice within a short period.

In view of the proposals, companies should carefully consider if early adoption of the 2020 amendments is appropriate.

Next steps

The comment period ended on 21 March 2022* and in its recent **ISSB Update** the Board discussed feedback on its proposals and how to proceed with the project.

* Read the **comment letter** (PDF 255KB) that we submitted in response to the Board's proposals.

3. Currently, the effective date of the 2020 amendments is for annual reporting periods beginning on or after 1 January 2023. These amendments have not been endorsed in the EU.

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