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Mr Hans Hoogervorst
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Our ref MV/288
Contact Mark Vaessen
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10 June 2015

Dear Mr Hoogervorst

Exposure Draft on Classification of Liabilities (Proposed amendments to IAS 1)

We appreciate the opportunity to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2015/1 *Classification of Liabilities – Proposed amendments to IAS 1* (the ED), published in February 2015. We have consulted with, and this letter represents the views of, the KPMG network.

We support the IASB's objective to clarify the criteria for the classification of a liability as current or non-current considering that the inconsistency between the existing requirements has caused much debate and confusion in practice. Whilst we agree that the areas where amendments have been proposed do require clarity, we are concerned that the proposals do not bring sufficient clarity and risk creating more confusion and diversity in practice. In particular, we are concerned that an inherent inconsistency between paragraphs 1.69(c) and 1.69(d) remains unresolved and the impact of future conditions on rights held at the reporting date continues to be unclear. Our concerns are illustrated by reference to common scenarios in response to Question 1.

In order to produce a more intuitive, consistently applied standard, we suggest that the IASB reconsider the proposals to provide a more holistic solution, which could also include improvements to other issues related to this area of IAS 1, such as how to classify derivatives as current or non-current, and how to estimate the current portion of a long-term loan.

In addition, we encourage the IASB to consider a broader rethink as to whether the concept of current/non-current classification remains relevant, given disclosures on liquidity risk and contractual maturity that are now required by other standards (e.g. IFRS 7); possibly as part of broader discussions within the Principles of Disclosure project.

However, if the Board proceeds with these amendments, above all we would welcome a clarification as to what is meant by the term 'right' so that preparers and users better understand the requirements of the standard, and the risk is reduced that users misinterpret an entity's rights as more than they are.

The Appendix to this letter contains our detailed responses to the questions on the proposals and other comments.

Please contact Mark Vaessen or David Littleford at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

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Appendix

This appendix contains our detailed responses to the proposals.

Question 1—Classification based on the entity's rights at the end of the reporting period

The IASB proposes clarifying that the classification of liabilities as either current or non-current should be based on the entity's rights at the end of the reporting period. To make that clear, the IASB proposes:

(a) replacing 'discretion' in paragraph 73 of the Standard with 'right' to align it with the requirements of paragraph 69(d) of the Standard;

(b) making it explicit in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and

(c) deleting 'unconditional' from paragraph 69(d) of the Standard so that 'an unconditional right' is replaced by 'a right'.

Do you agree with the proposed amendments? Why or why not?

No, we do not agree with the proposed amendments. As we explain further below, while we accept that the amendment may superficially align the (lack of) effect of future conditionality on, for example, each of:

i. a long-term loan that is conditional on future covenant tests; and

ii. a short-term loan that is capable of rollover subject to future conditions,

we are concerned that the range of the conditional 'rights' that may exist under (ii) is very wide. Accordingly, we are concerned that users may be misled by non-current classification of such short-term loans, an issue exacerbated by the diversity in practice that may result from a lack of clarity.

We believe that the current proposals lack the intended clarity because:

- they do not resolve the inherent inconsistency between IAS 1.69(c) and 1.69(d) with respect either to covenants or rollover arrangements; and

- they do not clarify the impact of future conditions on use of a right to defer settlement of a rollover facility.

Inconsistency between IAS 1.69(c) and 1.69(d)

We believe that there is an inherent inconsistency between IAS 1.69(c) and 1.69(d) that the amendments fail to resolve adequately.

The criteria in these two paragraphs are expressed as an "or" and therefore a liability is classified as current if either of the two criteria are met, i.e. when either the loan is due to be settled in less than 12 months or the entity does not have an unconditional right to defer settlement for that period. In other words, to be classified as non-current, the loan must be both due for settlement in more than 12 months and there must be an unconditional right to defer payment for that same period. This is not how the standard is applied in practice, and paragraph 73 of the standard, which explains one scenario (rollovers), is drafted as an exception to paragraph 69(c), which the ED acknowledges in BC8.

In respect of long-term loans that are subject to covenants, the inconsistency is only resolved by a legalistic assessment of conditionality *at the reporting date* that leads to the conclusion that conditionality after the reporting date, for example a covenant test in the next 12 months, does not result in current classification under paragraph 69(d).

We are concerned that the deletion of the word 'unconditional' from 69(d), and addition of the phrase 'at the end of the reporting period' will not resolve this inconsistency but rather risk contributing to increased confusion in practice.

To achieve consistency, we encourage the IASB to consider whether 1.69(d) is better treated as an exception to the criterion at 1.69(c) in all cases, rather than only rollovers – i.e. "the liability is due to be settled within 12 months after the reporting date <u>except when</u> an entity has an unconditional right to defer settlement for at least 12 months after the reporting period".

Impact of future conditions on a right to defer settlement of a rollover facility beyond 12 months after the reporting period

We believe that there remains a lack of clarity as to the impact of future conditions on a right held at the reporting date, which could result in significant diversity in practice.

The potential confusion can be illustrated in the following example, which contrasts:

- a long-term loan that contains conditions – i.e. covenants; and

- a short-term loan that can be rolled over with the same lender only if the same covenant conditions are met at the date of rollover.

Assume that an entity with a year end of 31 December has two liabilities:

Term loan of 1 million	**Rollover facility of 1 million**
• Five-year term loan, fully drawn down • Term loan drawn down at 1 October 20X5, with a due date of 30 September 20Y0 • Annual covenant test based on information at 30 September that renders the loan repayable on demand if breached	• Five-year facility • One-year loan drawn down at 1 October 20X5, with intent to roll over on 1 October 20X6 • Ability to roll over loan under the facility is conditional on compliance with the same covenant test as the term loan

For the purposes of this example, it is a given that both the term loan and the rollover facility do not meet the criteria in either 1.69(a) or 1.69(b) and that the ability to satisfy the covenant test is not wholly within the entity's control. The assessment is made at year end 31 December 20X5.

Under the proposed amendments, the entity would classify its term loan as non-current because it is not due to be settled within 12 months after the reporting period and it has a right <u>at the end of the reporting period</u> to defer settlement for at least 12 months after the reporting period. We would expect that this treatment is consistent with existing requirements and current practice.

For the rollover facility, the right to defer settlement is conditional and therefore arguably would not meet the exemption in paragraph 73, resulting in classification as current under existing IAS 1.

Some may believe that the two arrangements described above are economically similar and therefore that the standards would be rightly amended to make the post reporting date conditions irrelevant to the assessment under IAS 1.73 in these circumstances. They may conclude that the proposed amendments achieve consistent classification for the two arrangements.

Others may reach a different conclusion. They may consider that a right is not a real right unless it is capable of being exercised. Accordingly, they may conclude that a 'right' that can only be exercised in the future and only if there is compliance with post-reporting date conditions is not a 'right' at the reporting date.

It is unclear what the Board intended – i.e. whether the right held at the reporting date to defer settlement would be invalidated by the need to perform subsequent tests to determine if such right can be exercised, or whether to meet the criterion in proposed 1.69(d), an entity needs simply to hold a 'right' to defer settlement without consideration of subsequent conditions to exercise it.

Perhaps of greater concern is that the substance of such 'rights' may vary significantly. The nature of covenant tests, which are generally financial metrics set by the existing lender, are relatively consistent and generally understood. In comparison, the conditions that might apply to the rollover 'rights' may vary greatly. In particular, the nature of the conditions might increase the subjectivity and reduce the substance and enforceability of the right, for example they may be conditional on obtaining the lender's credit committee approval at a future date, on meeting lending suitability criteria, or on subjective conditions such as there being 'no material adverse changes' in the borrower's financial position.

We believe that deletion of the word 'unconditional' may create confusion, leading to more diversity in practice, not less. While the IASB identified varying interpretations of the word 'unconditional' during its October 2013[1] meeting, we note that the term 'unconditional' adds a certain level of rigour to the definition of a right, which is lost in its removal. We consider that its proposed removal leaves more room for interpretation of what a 'right' is because the term is now even less defined.

Compounding the aforementioned uncertainty is the proposal to remove the word (and concept of) an entity having 'discretion' to roll over an obligation for at least 12 months after the reporting period, as it is proposed that only a 'right' is needed. We are concerned that removal of the concept of discretion may contribute to instances where entities classify liabilities as non-current despite there being uncertainty or no reasonable expectation that a lender will allow the future exercise of a right – held at the reporting date – to defer settlement.

Overall, we are concerned that the IASB is making the proposed changes as an overly-narrow amendment whereas we believe it is an amendment that may have a significant impact on classification of liabilities. IFRIC staff noted a similar view during the September 2010[2] meeting:

> *In the staff's opinion, a change to the principle of an unconditional right to defer settlement for at least twelve months after the reporting period may significantly impact the current vs non-current classification of liabilities. Therefore, a change to this principle is not narrow*

While we have sympathy with an attempt to deliver consistent treatments for similar economic arrangements, we are concerned that the deletion of references to unconditional rights and discretion is not an appropriate solution in the absence of an explanation of what constitutes a 'right'. We believe a change to this principle is better considered as part of a broader, more comprehensive review (if possible, informed by the Principles of Disclosure project), and its impact would suggest it is beyond the scope of narrow, clarifying amendments as currently proposed.

[1] Agenda Paper 20, IASB October 2013 meeting
[2] Agenda Paper 16, IFRIC September 2010 meeting

We acknowledge that BC4–BC6 discuss rights and conditionality but, if the Board proceeds with this amendment, we urge the IASB to provide further guidance and clarification considering common contractual lending scenarios where a borrower's rights to defer settlement of its liabilities are subject to conditions that are assessed by lenders ***after*** the reporting date.

Otherwise, it remains unclear whether a 'right' that an entity cannot exercise until a future date, which is based on conditions that are uncertain to be met at that date, constitutes a right at all.

Question 2—Linking settlement with the outflow of resources

The IASB proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding 'by the transfer to the counterparty of cash, equity instruments, other assets or services' to paragraph 69 of the Standard.

Do you agree with that proposal? Why or why not?

We are in general agreement with the concept of the linking of settlement with the outflow of resources, but have the following concerns.

Concerns with additional paragraph in 1.69

It is not clear how the existing guidance in the last sentence of 1.69(d) interacts with the proposed additional guidance in 1.69. Specifically, existing guidance states that terms of a liability that could result in its settlement by an entity issuing equity instruments at the option of the holder do not affect classification; whereas the proposed additional guidance indicates that, for purposes of classification, settlement of a liability includes the transfer of equity instruments to the counterparty. The comments in BC14-BC15 augment, rather than diminish, this lack of clarity.

We interpret the existing guidance in 1.69(d) as rendering irrelevant to the classification issue any option of the counterparty to convert an otherwise cash-settleable liability into equity prior to the contractual cash settlement date (i.e. classification is based on the contractual cash settlement date, not the possibility that a counterparty may exercise its option to convert the liability to equity prior to that date). This may be read as contradictory to the proposed additional guidance in 1.69 that settlement in equity (regardless as to the issuer's or holder's option) is considered settlement of a liability, and as such would impact classification.

For example, Entity X has an obligation with a lender that will be settled for cash in 24 months, but the lender holds an option to require settlement of the obligation at any time prior by receiving a fixed number of X's equity instruments. In this scenario, we believe the guidance in 1.69(d) allows X to ignore the conversion option and consider only the cash-settlement date in classifying the obligation. However, 1.69 indicates that the transfer of equity instruments to the lender results in extinguishment of the liability and so is considered settlement for the purposes of current/non-current classification. These two approaches are opposing and thus it is unclear how X is to classify its obligation.

Therefore, we are concerned that absent additional explanation by the Board to clarify its intention with respect to these seemingly conflicting requirements, diversity in practice may arise. In finalising its proposals, we urge the IASB to clarify the intended interaction to ensure consistency in application.

If the Board considers that the existing guidance in IAS 1.69(d) does not conflict with the proposed additional guidance in IAS 1.69, we believe additional guidance is needed to clarify which types of conversion options to issue equity instruments would not affect classification. We note that the proposed additional guidance in 1.69 indicates that the transfer of cash or equity instruments *would* affect classification of a liability; however, it is not clear whether the issue of equity instruments under terms of a conversion option (such that classification is *not* affected) is meant to refer only to issuing a fixed number of equity instruments as defined in IAS 32.16(b)(ii). In other words, we are uncertain whether the conversion option must meet the 'fixed-for-fixed' requirement in IAS 32 (i.e. the issue of a fixed number of the entity's own equity shares) for classification not to be affected. We urge the IASB to explicitly clarify the nature of the conversion options to issue equity instruments that should be considered when assessing classification of liabilities.

Other concerns

We believe it is unclear whether there are any scenarios relating to 'rollover' that could constitute settlement of a liability. We recognise that BC8 notes that 'rolling over' can only occur with an "existing loan under an existing facility" and that BC12 states that the example in paragraph 73 does not constitute settlement because a rollover is the "extension" of an existing liability. However, it is unclear as to how an entity determines whether the new loan is an 'extension' or that it is the rolling over of an 'existing loan', as no criteria or considerations have been included in the amendments to guide an entity in making such a determination. We believe that scenarios exist in practice where the conclusion of whether a loan has been 'rolled over' – or instead has been settled and replaced by a new loan – may be unclear and therefore could result in divergent application.

For example, an entity rolls over a USD loan to one of an equivalent amount of Japanese Yen (JPY) for 12 months, all other terms unchanged. Some may consider that the rollover is an extension of the existing USD liability, as all other terms are the same and the amount is equivalent but simply expressed in a different currency. Others may argue that a change in currency necessarily requires an outflow of resources to exchange USD for JPY and as a result, settlement has occurred and a new loan is obtained. We encourage the Board to provide additional guidance and/or examples to clarify the extent to which rollover may result in settlement, if ever.

Question 3—Transition arrangements

The IASB proposes that the proposed amendments should be applied retrospectively.

Do you agree with that proposal? Why or why not?

While we agree with the Board that it should not be onerous for an entity to provide comparative disclosures, we wish to highlight that retrospective application would require entities to reclassify the presentation of liabilities in the prior-period, if affected. Arguably, this revised presentation of prior-period balances is no longer relevant by the date of authorisation of the current period financial statements. It could also pose operational difficulties whereby reclassifying liabilities as current (if applicable) in the comparative period's presentation might trigger a current-period breach of other non-current liability conditions, the compliance of which must have been met continuously over several periods at each reporting date.

We encourage the IASB to consider the relevance of its transitional proposals as it finalises these amendments.

Other comments

Finally, we note the discussion in BC 9–10 concerning rollover arrangements with same/different lenders and the conclusion expressed in BC11 to the amendment that the right "directly relates to the loan being classified … [and] … that the requirement that it must be an existing loan facility is already explicit in paragraph 73 [of the existing standard]".

We agree that it is clear that the relevant facility must be in place at the reporting date but we do not consider that it is explicit or even inferred that the rollover facility must be the same facility under which the liability being classified is drawn. If the Board considers that the proposed deletion of the word "refinance" from paragraph 73 achieves this, then we suggest it is explained in the BC. It also follows that neither is it clear that the lender of that facility must be the same. We suggest that the IASB clarify this point if it wishes to avoid diversity.