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Mr Hans Hoogervorst
International Accounting Standards Board
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Our ref RD/288

3 June 2020

Dear Mr Hoogervorst,

Comment letter on Exposure Draft ED/2020/3 *Classification of liabilities as current or non-current – Deferral of effective date – Proposed amendment to IAS 1*

We appreciate the opportunity to comment on the International Accounting Standards Board's ('the Board') Exposure Draft ED/2020/3 *Classification of Liabilities as Current or Non-current – Deferral of Effective Date – Proposed amendment to IAS 1* (the ED), published in May 2020. We have consulted with, and this letter represents the views of, the KPMG network.

We support the proposed deferral of the effective date of IAS 1 amendments on current or non-current classification of liabilities issued in January 2020 (the 'amendments').

However, we use this opportunity to bring to the Board's attention a potential ambiguity in the amendments. We are aware of different interpretations arising from the amendments in relation to a *right to defer settlement* of the liability for at least 12 months after the end of the reporting period. These different interpretations could make re-negotiations of covenants in loan agreements with lenders ineffective and may result in inconsistent implementation of the amendments. Without further clarification of the amendments, the proposed deferral of the effective date to allow more time for re-negotiations of loan covenants may not be as useful as intended.

Our primary concern is that the amendments may inadvertently change the current practice for classification of term loans and lead to a counterintuitive outcome – i.e. classifying at the reporting date term loans that are not due for settlement within 12 months after the reporting date as current, even though the lender does not have the contractual right to demand repayment and the borrower does not have the contractual obligation to settle the liability at that date, as illustrated in the following example.

Example – 5-year term loan with no breach of conditions on or before the reporting date

Fact pattern

- An entity has drawn down a 5-year term loan on 30 September 2020
- There are covenant tests which the entity has to comply with at every anniversary of the drawdown date (i.e. point in time covenant). The lender has the right to demand immediate repayment should the entity fail the tests/breach the contractual covenants
- The first covenant test would be on 30 September 2021 based on the entity's financial information on that date
- The entity is now preparing its annual financial statements for the year ended 31 December 2020 and assesses the classification at that date
- For the purposes of this example, it is a given that the term loan does not meet the criteria in either IAS 1.69(a) or 1.69(b) and that the ability to satisfy the covenant test is not wholly within the entity's control

Currently in practice, the term loan in the example above is classified at 31 December 2020 as non-current as it is not due for settlement within 12 months from the reporting date, either in accordance with its maturity or because of breaches of the covenant tests.

While we believe that the classification should remain unchanged under the amendments, we observe that some consider the new paragraph 72A to be applicable to term loans; consequently, classification of the loan would depend on whether the entity complies with the covenant tests at 31 December 2020, so as to determine if the right to defer settlement exists on that date. This is because the entity's right to defer settlement is subject to compliance with conditions and paragraph 72A of the amendments explicitly requires '*compliance of these conditions at the end of the reporting period even if the lender does not test compliance until a later date*'. As such, if the entity fails the compliance test at the reporting date, the term loan would be classified as current.

As in the above example, the conditions are only assessed by a lender after the reporting date (a compliance test is not performed until September 2021) this would be a counterintuitive outcome – i.e. the lender does not have a contractual right to demand repayment of the loan and the borrower does not have a contractual obligation to settle the liability at 31 December 2020. Some may argue that the application of a financial reporting requirement results in an inaccurate portrayal of the contractual rights and obligations of the lender and borrower in this case.

In addition, the applicability and relevance of paragraph 72A is also unclear in a scenario when there is a breach of covenant on or before the reporting date. A literal application of paragraph 72A would always lead to a current classification because the entity does not comply with the conditions, and therefore the right to defer settlement does not exist at the reporting period end. This seems to contradict the guidance in paragraph 75 which

states that such loan should be classified as non-current if the lender agreed by the reporting period end to provide a grace period ending at least 12 months after the reporting period. As such, the interaction of paragraph 72A with paragraphs 74 and 75 (unchanged in the amendments) is not clear.

The above example demonstrates the evolving ambiguity as to whether the new paragraph 72A applies to all liabilities, especially term loans.

We believe the ambiguity partly stems from the long-standing confusion in practice due to the inherent inconsistency between paragraphs 1.69(c) and 1.69(d) (i.e. expressed as “or” conditions) that we raised in our comment letter on the Exposure Draft ED/2015/1 *Classification of Liabilities – Proposed amendments to IAS 1*, published in February 2015. Some may read paragraph 69 that 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. Our recommendation at that time to achieve consistency was for the Board to consider whether 1.69(d) is better treated as an exception to the criterion at 1.69(c) – i.e. “the liability is due to be settled within 12 months after the reporting date except when an entity has an unconditional right to defer settlement for at least 12 months after the reporting period”. The amendments have not provided clarity in this regard and the introduction of new paragraph 72A has further exacerbated the confusion.

As the amendments and basis for conclusions do not explain the applicability of 72A and its interaction with existing (and unchanged) paragraphs 74 and 75, some seek clarity from previously published staff papers. These papers may suggest that the amendments apply to all liabilities including term loans, as the staff notes: ‘the purpose of the condition is to protect the lender’s interests and, to be effective, such protection must be in place continuously. So the entity’s right to defer settlement is implicitly conditional on continuous compliance, even if the lender tests compliance only from time to time.’¹ As illustrated in the example above, such continuous assessment may not reflect the contractual rights and obligations of the contracted parties. Terms and conditions of lending arrangements typically specify whether compliance with covenants is assessed at particular points in time or on a continuous basis. A financial reporting requirement cannot imply a condition exists (i.e. a continuous covenant) at a reporting date when such condition does not in fact exist in the lending arrangement agreed to by the contracted parties. A financial reporting requirement cannot imply the lender (borrower) has rights (obligations) at a reporting date beyond the rights and obligations that are agreed to between the contracted parties. We ask the Board to clarify its intentions regarding the applicability of paragraph 72A to term loans so as to resolve the developing ambiguity.

¹ See agenda papers 12B and 29B of the IASB meetings in February 2016 and March 2019 respectively



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We encourage the Board to consider providing further clarification in this regard and/or examples considering common contractual lending scenarios. Otherwise, the consistency of implementation of the amendments is at risk despite the timing relief proposed by the deferral of the effective date.

If you have any questions about our comments or wish to discuss any of these matters further, please contact Reinhard Dotzlaw or Gabriela Kegalj at +44 020 7694 8682.

Yours sincerely

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