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Ms Sue Lloyd
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Our ref RD/288

11 February 2021

Dear Ms Lloyd

Tentative agenda decision *Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements)*

We appreciate the opportunity to comment on the IFRS Interpretations Committee (the Committee) tentative agenda decision (the TAD) *Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements)* published in the December 2020 IFRIC Update. We have consulted with, and this letter represents the views of, the KPMG network.

We agree that the conclusions to the three illustrative cases in the TAD reflect the new IAS 1 requirements introduced by the amendments[1] insofar as they relate to covenants based on tests of financial position. However, we have significant concerns with these outcomes. We do not believe that debt classification based on a hypothetical test faithfully reflects the obligations that exist for a borrower at the reporting date based on the contract. As such, classification under the amendments will not provide useful information to users. We are also concerned about whether it is clear how to apply the amendments to other types of covenants, e.g. those based on tests of financial performance or qualitative covenants, and other types of financial liabilities. For these reasons, we recommend that the Committee does not finalise the TAD but instead refers the issues identified to the Board. We believe that the amendments need to be reconsidered before they become effective.

Given the significant impact of the amendments, we encourage the Board to consider a broader rethink of the underlying principle for current/non-current classification, and how such concept relates to disclosures on liquidity risk and contractual maturity that are required by other standards (e.g. IFRS 7).

[1] *Classification of Liabilities as Current or Non-current (Amendments to IAS 1 Presentation of Financial Statements)*

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Our key concerns are as follows.

Potential mismatch between the accounting classification and the loan's contractual terms and conditions

The amendments introduce a simple, objective test that requires compliance by the borrower with ***all*** conditions at the reporting date, including compliance with future conditions within 12 months after the reporting date. This *hypothetical* compliance test must be performed at the reporting date even if the loan agreement requires the test for compliance to be performed at a later date. While this test may be easy to apply (as illustrated in case 2 and 3 of the TAD), the use of such a hypothetical test may provide a counterintuitive outcome - i.e. how debt is classified for accounting purposes may not reflect the contractual rights and obligations of the contracted parties at the reporting date. The liability would be classified as current at the reporting date, yet 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 or even within 12 months after the reporting date.

Furthermore, we do not believe that debt classification based on a hypothetical test aligns with the core principle of reporting the substance of the contract (loan agreement) in the financial statements. The Conceptual Framework states that[2] "the terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance". The classification outcome does not faithfully represent the contractual obligations of the borrower at the reporting date.

The test also ignores the intended design of covenants that are negotiated to cater for an entity's specific circumstances. For example, a specific loan agreement may be designed to set different conditions at different dates because the contracted parties anticipate changes in the financial position or results of the borrower due to growth or down-sizing/right-sizing of its operations. These types of conditions are common for both start-ups and mature/stable entities undergoing restructuring. Similarly, due to the cyclical nature of some businesses, the design of the covenant may reflect the seasonality of the business, i.e. compliance is expected at a specific date(s) during the year but not necessarily at the reporting date.

In practice, the use of a hypothetical test would also mean that a loan's classification may change from one reporting date to another, including from one interim reporting date to another, without any actual breach of its contractual conditions having occurred. Users could reasonably question why such changes occur and entities would have to explain these changes to them. The only explanation seems to be that the classification

[2] Refer to paragraph 4.59 of the Conceptual Framework

outcome is based on the 'accounting rules' and the loan is classified as current despite no actual breach having occurred.

Furthermore, because the classification of debt would be based on a hypothetical rather than an actual test, there may be no remedy[3] available to the borrower to achieve non-current classification. This is because no lender will waive their right to call a loan in respect of a breach if that breach did not actually occur, i.e. there is nothing to waive.

Overall, we do not believe the approach introduced by the amendments results in an outcome that provides relevant information to users of the financial statements. An accounting approach that largely disregards contractual terms would not provide useful information to investors about the borrower's financial liabilities in the statement of financial position. In fact, the approach may confuse users when they read the contractual maturity information provided in the notes[4]. Furthermore, there appears to be a disconnect between the suggested approach that considers a hypothetical breach at the reporting date as the driver for current classification in the statement of financial position (without possible remedy) and the disclosure requirements in IFRS 7[5] - i.e. the disclosure of hypothetical breaches at the reporting date is not currently considered in this Standard but only actual breaches. Similarly, this approach may be viewed as inconsistent with going concern disclosures that arise from a borrower's going concern assessment that reflects anticipated covenant breaches based on contractual testing dates.

Instead of impacting classification on the statement of financial position, information about hypothetical covenant compliance could be useful disclosure for users. We therefore recommend that the Board consider more broadly what type of information would be most useful to users, e.g. hypothetical compliance with future conditions at the reporting date, expected compliance with conditions at future dates or both. This may best be considered in the broader context of an entity's going concern disclosures. We note that the topic of going concern has been identified as a potential agenda item to be covered in the Board's upcoming agenda consultation (per the educational material published by the IFRS Foundation in January 2021) so perhaps this could be addressed as part of any future project on going concern.

TAD covers only covenants based on tests of financial position

While the TAD refers broadly to classification of debt with covenants, it illustrates loans with covenants that test conditions only based on the borrower's financial position (e.g. a required working capital ratio). The TAD does not clarify if/how classification of a loan with a financial performance condition (e.g. annual revenue / earnings target to be

[3] Refer to paragraph 74-75 of IAS 1
[4] Refer to paragraph 39 of IFRS 7
[5] Refer to paragraphs 18-19 of IFRS 7

tested after the reporting date) or qualitative covenants (e.g. submission of audited financial statements of the borrower by a certain date / change in control clauses) would be affected by the amendments.

Since the amendments apply to all financial liabilities, not only to loans with financial position covenants, we believe the clarification in the TAD is insufficient to achieve consistent application of the amendments. Additional application issues will arise in the absence of a clear articulation of the underlying principle across a much wider set of examples of liabilities.

A clear explanation is needed as to what the 'right to defer settlement' actually means and how a borrower is to assess appropriately and consistently whether such right has substance. While the 'substance' criterion was introduced by the amendments, there is limited guidance in the amended IAS 1 on how to determine whether a right has substance. This could lead to different interpretations arising in practice. For example, some may argue that any counterintuitive classification outcomes can be overridden based on the 'substance' requirement in paragraph 72A itself.

In summary, with the TAD covering only loans with a financial position covenant, we believe that the Board's objective of reducing diversity in practice in the classification of liabilities under IAS 1 will not be achieved.

Our detailed comments on the cases included in the TAD are set out in the Appendix to this letter. This includes an additional case illustrating a term loan with a financial performance covenant.

Please contact Reinhard Dotzlaw at reinhard.dotzlaw@kpmgifrg.com or Gabriela Kegalj at gabrielakegalj@kpmg.ca if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix

Our specific comments on the three cases are outlined below.

Case 1

Based on our understanding of the fact pattern in Case 1, we understand that the loan would be classified as current applying existing paragraph 75 of IAS 1, which remains unchanged in the amendments. The TAD is currently silent on the applicability of paragraph 72A in this case and it solely refers to paragraph 75.

It would be useful to clarify in Case 1 the relevance of paragraph 72A – presumably the entity (the borrower) also does not have a right to defer settlement at the reporting date as it fails the hypothetical test at 31 March, 30 June and 30 September 20X2. Otherwise, it is unclear how the conclusion in this case relates to the overall conclusion in the TAD that explains the application of paragraphs 69(d) and 72A in assessing the borrower's right to defer settlement of the loan. To avoid continued ambiguity, it would also be helpful to clarify what the waiver from the lender is actually for.

Our understanding of the facts presented in this case is that the future tests at 31 March, 30 June and 30 September are not removed by the waiver, i.e. the future tests will need to be performed at those dates per the loan agreement. Rather, the lender only agrees, prior to the reporting date, not to call the loan at any time in the next three months as a result of the covenant breach as at 31 December, i.e. the lender is waiving its right to call the loan in respect of a specific covenant breach and thereby providing three months for the borrower to rectify the breach. While we do not disagree with the conclusion in this case, we believe the amended IAS 1 provides two reasons why the borrower does not have a right to defer settlement of the loan: first, the period of grace is insufficient (paragraph 75 requirement is not met) and second, the entity fails the hypothetical test of compliance at the reporting date (per paragraph 72A) with future conditions at 31 March, 30 June and 30 September 20X2. The TAD fails to recognise the application of paragraph 72A in this case.

In contrast, in some circumstances, a borrower may obtain from a lender – before the reporting date – an agreement to amend a loan arrangement (typically it is a bilateral agreement to change certain terms and conditions of the existing arrangement). Such amendments may defer the date as at which information is assessed for testing covenant compliance from a date at or before the reporting date to a later date. Alternatively, amendments might completely remove the specific covenants from the loan arrangement. We believe that under existing IAS 1, in such situations, whether the borrower would have breached the related covenant had the agreement not been amended does not affect the classification of the liability at the reporting date – i.e. there is no breach under the amended agreement and paragraphs 69(d) and 75 are not relevant. However, under the amended IAS 1, when the tests at future dates (31 March,

30 June and 30 September) are not changed or 'waived', applying paragraph 72A in such case, the borrower would fail the hypothetical test and the liability would be classified as current.

As such, it would be essential to explain in Case 1 what the waiver is actually for, and the (possibly multiple) reasons for the conclusion.

Case 2

While we agree with the Committee's conclusion in Case 2, we believe that the case illustrates our concerns outlined in the cover note.

Classifying the loan as current based on a hypothetical test creates a mismatch between the accounting outcome and the contractual rights and obligations of the contracted parties at the reporting date – i.e. as at 31 December 20X1 the lender does not have the right to demand repayment of the loan and the borrower does not have the obligation to repay it. Furthermore, as the test in this case is hypothetical, if the borrower 'breaches' a hypothetical test it would need to classify the loan as current and may not have any remedy available to achieve non-current classification (a waiver as per IAS 1.75). This is because no lender will waive their right to call a loan in respect of a breach if that breach did not actually occur, i.e. there is nothing to waive.

Crucially, the conclusion ignores the seasonality of businesses. Typically, seasonality of the business would be taken into account when the contracted parties are negotiating covenant clauses in loan agreements – i.e. the conditions are designed to be met at specific dates as stated in the loan agreement, not throughout the year.

Case 3

While we agree with the Committee's conclusion in Case 3, we have similar concerns as described for Case 2 and highlighted in our cover note.

The outcome seems to be even more controversial in this case. This is because the borrower actually satisfies the contractual test at the reporting date but fails the hypothetical test at that date. Consequently, it classifies the loan as current as at 31 December 20X1. Similar to Case 2, it may not be possible for the borrower to obtain a waiver from a lender because it actually complies with the condition that it is contractually required to meet on 31 December 20X1 under the loan agreement. There is no breach of the covenant as at 31 December 20X1, so there is nothing for the lender to 'waive' – the lender does not have the right to call the loan. The conclusion does not seem to take into account why conditions such as those described in the case are set in the first place – i.e. the loan agreement may be deliberately designed to set different conditions at different dates because the contracted parties anticipate changes

in the financial position or results of the borrower due to growth or down-sizing/right-sizing of its operations, or because of seasonality of the business.

The explanation behind the hypothetical test approach included in the two Staff papers[6] states that "the purpose of the [future] 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." We do not believe that such an approach is consistent with the contractual terms and it seems to ignore the intended design of specific covenants. Under this approach, to classify a loan as non-current for accounting purposes, a borrower would need to comply with the conditions specified in the loan agreement at all times, even if the loan agreement was negotiated to cater for a borrower's specific circumstances at a specific point in time. We believe that in fact patterns such as Case 3 it is entirely possible that the lender expects different conditions for compliance over the loan term while still managing its risk, as demonstrated by the different conditions on different dates.

Covenants not based on tests of financial position

While all three cases in the TAD focus on term loans with a condition related to a borrower's financial position (i.e. working capital ratio), the TAD does not address how the amendments would apply to a term loan with a condition related to financial performance. This is illustrated in the following example.

Example – term loan including a financial performance condition with no breach of covenant on or before the reporting date

An entity (the borrower) has a term loan fully drawn down at 1 July 20X1, with a due date of 30 June 20X6. The loan outstanding at 31 December 20X1 has the following contractual terms:

a. the loan includes a covenant that requires the borrower reach a cumulative revenue threshold above CU10 000 per year, over the period from 1 July to 30 June of each year. This covenant is therefore tested at each 30 June. The loan becomes repayable on demand if the cumulative threshold is not met at any of the testing dates.
b. the borrower earned revenue of CU5 700 for the period from 1 July 20X1 to 31 December 20X1. The borrower expects to exceed the cumulative revenue threshold of CU10 000 at 30 June 20X2.

Question: should the borrower classify the loan as current or non-current at its 31 December 20X1 reporting date?

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

Currently in practice, the loan in the example above is classified at 31 December 20X1 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 test. However, it is not clear what the classification would be under the amendments.

The borrower's right to defer settlement is subject to compliance with a specific condition, and paragraph 72A of the amendments explicitly requires compliance with these conditions "at the end of the reporting period even if the lender does not test compliance until a later date". In the above example, the borrower does not comply with the cumulative revenue threshold at the reporting date as it has earned revenue of only CU5 700 from 1 July 20X1 to 31 December 20X1. As such, some may interpret the amendments to result in the loan being classified as current at 31 December 20X1. This would seem to be a counterintuitive outcome since the lender does not expect the borrower to meet the revenue threshold within a 6-month period, and this is reflected in the design of the covenant based on the borrower's business/stage of operations. Furthermore, the lender does not have a contractual right to demand repayment of the liability and the borrower does not have a contractual obligation to settle the liability at 31 December 20X1.

Others, based on reading paragraph BC48E, may interpret the amendments to result in the loan being classified as non-current at 31 December 20X1. BC48E describes the Board's considerations regarding how management assesses an entity's compliance with a condition relating to the entity's cumulative financial performance for a period extending beyond the reporting period. The Board concluded that "comparing the entity's actual performance up to the end of the reporting period with the performance required over a longer period would not provide useful information—one of these measures would have to be adjusted to make the two comparable". However, the Board decided not to specify a method of adjustment, citing that any single method could be inappropriate in some situations.

We note that the Staff considered the relevance of paragraph BC48E in its December 2020 IFRIC agenda paper. The Staff noted "We think paragraph BC48E discusses the Board's observations on the application of paragraph 72A of IAS 1 to particular conditions relating to an entity's cumulative financial performance—not conditions relating to an entity's financial position. That is, we think paragraph BC48E is referring to circumstances in which an entity's actual performance up to the end of the reporting period reflects a shorter period of performance than specified in the condition (eg actual revenue for nine months and a covenant requiring a particular level of revenue over a twelve-month period)—and the Board observed that one of those measures would have to be adjusted in order to provide useful information."[7]

[7] See agenda paper 2 of the IFRIC meeting in December 2020

It is not clear what the classification in the above example would be under the amended IAS 1. The possibility of adjusting measures, or guidance to be applied in making such an adjustment in the calculation of the hypothetical test, is not clear from the amendments. Furthermore, the Basis for Conclusions is not an integral part of IAS 1 and does not contain requirements—it accompanies the Standard, explaining the reasons for the Board's decisions in developing the requirements in the Standard.

Other financial liabilities and other covenants

While we have illustrated one example of a loan with a financial performance condition, there are many other types of arrangements that are common in practice for which the application of the amendments may not be clear or the outcome may prove to be counterintuitive, for example:

— Loan agreements with conditions that trigger the immediate repayment of debt when there is a change in control of the borrower;

— Loan agreements with subjective conditions such as there being 'no material adverse changes' in the borrower's financial position;

— Loan agreements with qualitative covenants such as the submission of audited financial statements by a certain date;

— Contingently issuable shares that meet the definition of debt under IAS 32;

— Pre-IPO preference shares with contingent settlement provisions;

— Financial guarantee contracts in which the settlement is conditional on the credit risk of the guaranteed entity; and

— Loan agreements with 'cross-default' covenants – e.g. where the classification of one loan as current (based on a hypothetical test) causes the covenants on other loans or contractual arrangements to be breached.

We believe that in absence of further guidance and/or illustration of how to apply a principle for current/non-current classification, the ambiguity will not be resolved and consistency of implementation of the amendments is at risk.