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July 10, 2015

Hans Hoogervorst
Chair
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Comment Letter on Classification of Liabilities

Dear Mr. Hoogervorst,

The CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the International Accounting Standards Board ("IASB" or the "Board") Exposure Draft, *Classification of Liabilities: Proposed Amendments to IAS 1* (the "Éxposure Document" or "ED").

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

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1 With offices in Charlottesville, New York, London, Brussels, Hong Kong, Mumbai, Beijing, CFA Institute is a global, not-for-profit professional association of more than 130,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 150 countries, of whom nearly 123,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

OVERVIEW

Robust classification principles and comprehensive disclosures that incorporate covenant and indenture restrictions are important to users of financial statement data because the appropriate classification of/distinction between an entity's current and non-current obligations impacts investors' analysis of the following:

- Refinancing risk;
- Liquidity risk; and
- Working capital utilization and efficiency.

Given that the classification of current vs. non-current liabilities is important and has a bearing on how investors assess relative financial risk across reporting entities, we are assuming that the intention of the ED is to: a) enable reporting entities to more faithfully represent their short-term obligations; and b) eliminate the currently observed diversity in reporting practice due to varied interpretations of International Accounting Standards Statement No.1, *Presentation of Financial Statements* ("IAS 1") requirements. In general, investors would be concerned about preparer bias[3] towards classifying liabilities as non-current liabilities and, therefore, it is necessary to have robust guidance and disclosures that underpin this classification choice.

That being said, in our opinion, the ED does not adequately articulate the pervasiveness of the concerns being addressed by the clarification, nor does it convey the practical consequences of the proposed changes. It would have been helpful for this ED to have provided several additional illustrative examples of liabilities and circumstances surrounding where the purported confusion has arisen and necessitated clarification. Investors and other stakeholders would then be better placed to assess whether the anticipated reporting outcomes, as a result of the proposed wording changes, lead to comparable reporting and conforms to a faithful representation of economic obligations to a greater extent than is the case under existing requirements.

RESPONSE TO EXPOSURE DRAFT QUESTIONS

QUESTION 1 - Classification Based on Entity's Rights at the End of the Reporting Period

As we understand, the amendment mainly pertains to the fourth criterion for recognizing current liabilities, namely that 'an entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.' The amendment proposes to:

- replace 'unconditional right' with 'right';
- make it explicit that the right to defer settlement is in place at the reporting date;
- replace 'an entity not having the discretion to rollover liabilities' as contained with the language of existing requirements with 'an entity not having the right to rollover liabilities'.

From our reading of the ED, it seems to be that there has been confusion amongst preparers regarding the nature of rights and the timing of the assessment of rights that dictate the classification of liabilities. Confusion also seems to exist on how to judge whether liabilities that

[3] The famous case of Penn Central Railroad comes to mind. Penn Central Railroad was deep into short-term debt that it classified as long-term debt with the belief that it had commitments from lenders to keep refinancing the short-term debt.

are expected to mature within 12 months after year end have been rolled over. The Paragraph BC4 of the Basis of Conclusion expands and clarifies that both the conditional and unconditional rights prevailing at reporting date are the relevant classification determinants. As we understand, the main issue here is that there has been a varied interpretation of the meaning of 'unconditional right' and Paragraph BC2 asserts that an unconditional right to defer settlement rarely exists. We understand that deleting 'unconditional' is meant to help to clarify that companies with conditional rights (e.g. needing to meet pre-specified leverage levels) to rollover debt that matures in 12 months ought not to be precluded from classifying such debt as non-current liabilities.

However, deleting the word 'unconditional' without explicitly clarifying the form of rights that borrowers need to have for the appropriate classification, does not, to our mind, resolve the underlying ambiguity surrounding current IAS 1 requirements nor does it empower users to assess the economically appropriate application of reporting entity's judgments and as we discuss below, it is necessary to enhance the related disclosures (e.g. covenants). This amendment could arguably make the overall IAS 1 requirements to be even more subjective than is currently the case. The ED, in its proposed resolution, seems to address the confusion around interpretation of the nature of rights (conditional vs. unconditional) by focusing on the confusion that may exist around the timing of assessment of rights (before, at or after the reporting date).

Furthermore, the ED does not adequately demonstrate that the particular words being deleted or substituted were the primary root causes of the described diversity in reporting practice. With the principal focus of the proposed amendments being on word refinement, there is the real risk of overlooking the need to adequately describe, further develop and better articulate the underlying principles. In our opinion, there needs to be an improved articulation of the overall required preparer decision process – and disclosures regarding such a decision process – including the terms of refinancing and rollover that affects any judgments made on the intention, ability and probability of the borrower to extend debt maturing within 12 months after reporting date.

As we understand, the following factors need to be considered whilst assessing a borrower's intention, ability and probability of extending short-term debt that contractually matures within 12 months after the reporting date:

- Borrower contractual arrangements with its lenders to extend (i.e. rollover) existing debt without replacement financing (i.e. no settlement);
- Lender-borrower covenant terms that impose conditions (e.g. leverage, working capital levels) that have to be in place prior to debt rollover;
- Borrower rights at reporting date vs. rights that could arise after reporting date but before the contractual maturity date;
- Accessibility to additional/replacement financing by the borrower (i.e. backstops)

With the above factors being determinative of whether to classify liabilities as either current or non-current, there is need to unambiguously and explicitly delineate how each of these factors affect the classification of liabilities rather than doing so by implication as seems to be done for some scenarios (e.g. refinancing). The ED re-wording seems to imply that refinancing does not affect classification of liabilities. In other words, if a company can borrow from 'counterparty

Peter' to pay 'counterparty Paul', then what is owed to Peter has to be classified as a current liability. Effectively, it seems to be that only the ability to rollover and not to refinance short-term debt results in classification of liabilities as non-current. Nevertheless, one has to infer how to treat refinancing rather than it being directly stated in the proposed revised standard requirements.

Another issue is that stakeholders have long sought clarity on how the potential change in identity of a consortium of lenders under a syndicated lending arrangement influences the judgment of whether a rollover versus refinancing is expected to occur and thereafter whether the obligation is eligible for non-current liability classification. As we understand, there has been a question of whether a consortium of lenders is equivalent to the same lender. Paragraph BC11 highlights the Board's conclusion that the rollover agreement does not need to be with the same lender. Instead the Board has decided that emphasis should be placed on there being a right at the end of the reporting period to rollover the obligation under the existing loan facility that directly relates to the loan being classified. It would appear that the Board assumes that it has resolved the question of how the identity of lender/consortium of lenders affects liabilities classification, by clarifying that it is borrower rights at reporting date that matter. Said differently, it is the right to rollover rather than who it is rolled over to which the Board is focusing on. If this interpretation of the Board's conclusion is correct, it would seem like the Board is assuming that the articulation of a broad principle (i.e. only borrower rights at reporting date are relevant) within the standard, dispenses of the need to resolve the confusion regarding the impact of identity of consortium of lenders on liabilities classification. We are not certain that the underlying confusion has been sufficiently resolved by the updated requirements.

We assume that due to the mentioned misinterpretation of the existing standards requirements (i.e. nature of rights, timing of assessment of rights, criterion of judging rollover status), there is a high likelihood that there are some companies that are at least sometimes wrongly classifying their liabilities. At the same time, the lack of specificity regarding the nature of rights (conditional and unconditional) that are relevant for classifying liabilities as current versus non-current, makes it difficult for investors to robustly evaluate the criteria that preparers are applying in their classification of liabilities. It is hardly surprising, that investors have not been aware of the likelihood of misclassification of liabilities that currently exists. Hence, for investors, the central questions going forward will be:

- Whether and how will reporting outcomes change as a result of the updated guidance?
- To what extent does the updated standard equip investors with the ability to monitor, challenge and make analytical adjustments of reported current versus non-current liabilities?

Overall, we recommend strengthening the articulation of principles and judgments and enhancing disclosures as we elaborate on further below.

Strengthen Articulation of Principles and Judgments

The ED provides several examples and fact patterns that impact on the classification of liabilities. We agree that the relevant rights for reporting purposes are those that are in place at the reporting date and that a clarification of what constitutes settlement as part of identifying when debt rollover has occurred is helpful. We would also agree that replacing 'discretion' with 'right' in Paragraph 72R - lessens the overall ambiguity of existing requirements. That said, as we have described earlier, the final standard should provide a more comprehensive articulation of conditions (i.e. rights and obligations) that are applicable prior to companies being allowed to classify any liabilities due in the next 12 months, as non-current liabilities.

Enhance Disclosures Related to the Classification Choice

As we understand, preparers have not been classifying liabilities where they have conditional rights to defer settlement as non-current liabilities. We conclude that more liabilities will now be classified as non-current liabilities. At the same time, investors have concerns about short-term obligations being misclassified as non-current liabilities. Thus, there is a need to enhance disclosures that help investors to be aware of any lending arrangements that have a bearing on the effective maturity of the debt. We recommend required disclosures of the following:

- *Covenants*: Companies should be required to disclose conditional borrower rights (e.g. fulfilling a specified leverage ratio, maintain working capital levels) within covenants that have a bearing on the liabilities classification. These disclosures will allow investors to identify any rights to defer debt settlement that are subject to the borrower meeting certain conditions and provide context to the reported liabilities classification.

- *Sources of Liquidity*: Investors need to understand the alternative sources of liquidity that are at the disposal of the reporting entity in order to effectively assess the refinancing risk.

QUESTION 2 - Linking Settlement with the Outflow of Resources

The IASB proposes to clarify 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. We agree with this proposal and the assertion that a rollover of debt does not constitute settlement. Notwithstanding the clarification, there is need to explicitly define the conditions where a rollover can be assumed to have taken place. We also recommend that there should be a required disclosure of situations where companies have rolled over their debt.

QUESTION 3 - Transition Arrangements

The IASB proposes that the amendments should be applied retrospectively. We agree with the retrospective as the classification impacts on analytical ratios and there is need for comparable and standard effects information during the transition period.

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Thank you again for the opportunity to comment on the ED. If you or your staff have questions or seek further elaboration of our views, please contact either Vincent Papa, PhD, CFA, by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org or Sandra J. Peters, CPA, CFA by phone at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

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CFA Institute

/s/ Ashwinpaul C. Sondhi

Ashwinpaul C. Sondhi
Chair
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