STAFF PAPER

April 2021

IFRS® Interpretations Committee meeting

Project	**Classification of Debt with Covenants as Current or Non-current (IAS 1)**
Paper topic	Comment letters

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Introduction

1. This paper reproduces comment letters on the IFRS Interpretations Committee's tentative agenda decision 'Classification of Debt with Covenants as Current or Non-current (IAS 1)' published in December 2020.

Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

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Sue Lloyd
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IFRS Technical Committee
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Berlin, 22 January 2021

Dear Sue,

IFRS IC's tentative agenda decision in its December 2020 video conference

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the tentative agenda decisions taken by the IFRS Interpretations Committee (IFRS IC) as published in the December 2020 *IFRIC Update*.

We agree with all tentative agenda decisions and deem an appropriate application of the literature. Notwithstanding our agreement, we provide additional comments on two of these.

We consider the tentative agenda decision on IAS 1 (Classification of liabilities with covenants as current or non-current) constituting an appropriate description of how to apply the requirements of IAS 1 that had been amended recently. In this context, we deliberated again the underlying principles. Our finding is that under certain facts and circumstances – e.g. Case 3 that the IFRS IC had discussed – the resulting classification of liabilities may appear counter-intuitive. According to paragraph 72A of IAS 1, an entity must comply with the conditions at the end of the reporting date even if the lender does not test compliance until a later date. Given that contractually agreed covenant hurdles may vary depending on the (interim) reporting period they relate to (e.g. reflecting the seasonality of an entity's business), paragraph 72A of IAS 1 may lead to a breach of a condition at the reporting date, although, from an economic perspective, the entity does not need to comply with that condition until a later testing date. As classification depends on the (non-)compliance with the condition at the reporting date, management's expectations (regarding future compliance with covenants) would not be reflected. However, we believe that, in practice, entities will likely adapt their contractual agreements in a way that ensures a classification that appropriately reflects the economic substance of their lending agreement (e.g. obtain a waiver for at least 12 months after the reporting date).

As regards the tentative agenda decision on IAS 38 (Accounting for configuration or customizing costs with SaaS arrangements), the IFRS Technical Committee considers that the reference to IFRS 15 – to be applied by analogy – may imply that the timing of cost to be recognised by the entity would have to mirror the revenue recognition pattern of the arrange-

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Prof Dr Sven Morich

ment's counterparty. We wonder whether this conclusion would be appropriate for all fact patterns or would only apply in certain circumstances. In case of the latter, we suggest clarifying and amending the agenda decision. Further, it appears unclear whether and how the findings by the IFRS IC would apply were the customizing service performed by a third party. Again, we suggest a clarification in this regard.

If you would like to discuss our views further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Sven Morich

Executive Director

January 25 2021

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Classification of Debt with SOCPA Comments on Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

Dear Colleagues,

The Saudi Organization for Certified Public Accountants (SOCPA) appreciates the efforts of the IFRS Interpretations Committee (Committee) and welcomes the opportunity to comment on the *Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1).*

We agree with the Committee's conclusion that the principles and requirements in IFRS Standards provide an adequate basis for the entity to determine how to classify the loan as current or non-current in the three fact patterns described in the tentative agenda decision. In fact, the cases presented are straightforward and pose no question, as it is very easy to apply the requirements to them. Therefore, it is preferably to issue these cases as an education material rather than an agenda decision. Another alternative is to issue such cases within part B of the Red Book.

The problematic requirement of the amendment, however, rests with the meaning of 'substance' in context of the requirements in paragraph 72A. That paragraph states that "an entity's right to defer settlement of a liability for at least twelve months after the reporting period must have substance…". It is not clear what the Board would like to accomplish, or rule out, by the inclusion of this requirement. The basis for conclusion accompanying the amendment does not offer any explanation. Therefore, we appreciate if the Committee offers an interpretation of this requirement, preferably with some examples.

Please feel free to contact Dr. Abdulrahman Alrazeen at (razeena@socpa.org.sa) for any clarification or further information.

Sincerely,

Dr. Ahmad Almeghames

Secretary General

PETROBRAS

Rio de Janeiro, February 3, 2021

CONTRIB 0010/2021

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IFRS Interpretations Committee
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Subject: Classification of Debt with Covenants as Current or Non-current (IAS 1)

Reference: Tentative Agenda Decision (TAD)

Dear Ms. Lloyd,

Petrobras welcomes the opportunity to comment on the IFRS Interpretations Committee's Tentative Agenda Decision - Classification of Debt with Covenants as Current or Non-current (IAS 1). We believe this is an important opportunity for all parties interested in the future of IFRS and we hope to contribute to the progress of the Committee's activities.

The conclusions reached by the Committee regarding the application of paragraph 69(d) of IAS 1, as amended in January 2020, clarify the classification of liabilities as current or non-current for the three particular fact patterns described in the TAD. However, it is still not clear how the amendments would apply for covenants unrelated to balance sheet outstanding balances, e.g. entity's compliance with a condition relating to the entity's cumulative financial performance (profit or other metric related to profit) for a extending period beyond the reporting period. We believe the inclusion of an example related to this would be helpful and provide consistent application.

We also noted that some of the conclusions reached by the Committee were based on the application requirements provided by paragraph 72A as amended and without this paragraph the conclusions might have been different. It is worth mentioning that the guidance within paragraph 72A was not included in the ED 2015/1 that proposed amendments to IAS 1. Consequently, it was not exposed for public comment.

Among other things, paragraph 72A as amended determines that the entity must comply with the conditions to defer settlement at the end of the reporting period even if the lender does not test compliance until a later date. Such requirement disregard the entity´s expectations and may cause frequent reclassifications of a liability between current and non-current. Such outcome may be viewed as a potential for confusion.

In this sense, we recommend to the Committee not to issue a final position in relation to the fact patterns in the Agenda Decision and to submit the matter first to the Board. Considering that they are based on a paragraph that was not contained in ED 2015/1 and that the application of the requirements as set out in the Agenda Decision can generate unintended consequences and potential for confusion. We also emphasize that submission to the Board is an alternative provided for in the Due Process Handbook, paragraph 8.2 (d).

If you have any questions in relation to the content of this letter, please do not hesitate to contact us (cc-contrib@petrobras.com.br).

Respectfully,

/s/Rodrigo Araujo Alves
Rodrigo Araujo Alves
Chief Accountant and Tax Officer

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afep

Mouvement des Entreprises de France MEDEF

The IFRS Interpretations Committee,

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United Kingdom

Dear Ms Lloyd,

Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

We would like to express our concerns with both the due process and the outcome that will result from the above Tentative Agenda Decision (TAD) relating to the classification of debt with covenants.

Concerning the due process, we note that:

The paragraph IAS 1 72A, on which the IFRS Interpretations Committee (the Committee) has based its conclusion, was added after the publication of the exposure draft published in 2015 and was therefore excluded from the normal due process for exposure draft feedback.

There is no element in the basis for conclusion in the amended IAS 1 to explain why this paragraph was added (except to state its objective, that is, that it was added to clarify that an entity's right to defer settlement is subject to compliance with specified conditions but with no supporting explanation compared to the core standard).

The conclusion reached by the Committee is not obvious and clear-cut and other interpretations could be made; the Committee appears not even to have considered alternative views.

The outcome that will be obtained with the decision exposed in the TAD is not appropriate or useful; such a reading of the amendments indicates that these amendments themselves should be fully debated in a proper due process

The relevant amendment of IAS 1 will not be effective before 1 January 2023; in our view, this leaves enough time to undertake a standard-setting process.

C**oncerning the interpretation and the final expected outcome:**

We agree with the core principle that only rights and obligations existing at the reporting date should be considered in order to classify liabilities; intention and/or management expectation should not be used to decide on this classification.

Reading paragraph 72 A, we note that the right should exist at the end of the reporting period, which also means that the obligation to comply with the condition should also exist at this date. With no obligation to comply at the end of the reporting period, the right to defer cannot be questioned.

The same paragraph specifies that "The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date". We do not share the Committee's interpretation of this statement. Indeed, this requirement could also be considered to deal with the case where the terms (the conditions) of the covenant are based on figures as of 31.12.N but which, for practical reasons, cannot be effectively tested for compliance before March N+1 (because audited financial statements are required by the lender). In this case, we agree that the classification will depend on the assessment based on 31.12.N figures, even if the lender will test compliance at a later date.

However, we do not believe that this paragraph should be viewed as also dealing with other circumstances in which both parties have agreed that the covenant will be tested at a date other than the end of the annual reporting period. In cases 2 and 3 of the TAD, we believe that the right to defer settlement is not subject to a condition as at the reporting date because in Case 2 the condition is not based on the ratio at the end of the annual reporting period and in Case 3 the second part of the condition does not exist until a future date. There is no obligation based on 31.12.N figures. With no obligation on this date, no one could argue that the liabilities should be settled within less than 12 months. The right to defer settlement could never be breached as at the end of the annual reporting period–it could be breached only at an interim date because the condition only exists at a specified future date (31 March or 30 June). The test of a condition is not the same thing as the condition: the test confirms that the condition has been met, it is not a condition in itself.

Naturally, if the entity expects that the future covenant will be breached, appropriate disclosure will be needed.

We therefore believe that the TAD contradicts the terms of the contractual agreement and does not faithfully depict the arrangement and the economic situation. We believe that the classification proposed may go far beyond the intention and legal reality of contracts. We believe that covenants are negotiated with full consideration of the specific operating environment of the entity and the specific purpose of the contract. For example, entities that operate in a seasonal or cyclical activity or which have predictable periodical high cash inflows, will take care to ensure that the dates at which the compliance with covenants has to be confirmed take into account this cyclical environment.

Take the following example: an entity with a year-end date of 31 December borrows for 5 years; each year the bank examines the entity's debt-to-equity ratio and may demand early repayment if the ratio is greater than x%. Given the seasonal activity of the entity, the lender and the borrower have agreed that the ratio is to be considered and reported as of 1 March, since, because of this seasonal activity, the covenant would always be breached if it were computed with figures as of 31 December (the reporting date). The intention of the two parties is clearly not to cause the covenant to be breached in the normal course of events. We believe that it is neither relevant, nor faithful, to present the liability as a current debt because the covenant is not effectively breached at the reporting date. If significant, information should be disclosed in notes.

If you require any further information on this subject, please do not hesitate to contact us.

Yours sincerely,

ACTEO	AFEP	MEDEF
Lise CHORQUES	Lé Quang TRAN VAN	Karine MERLE

IFRS Interpretations Committee
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10th February 2021

Dear Sir/Madam

Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

We are commenting on the above tentative agenda decision, published in December 2020, on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the rejection. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Technical analysis of the tentative agenda decision

We do not consider that either the amendment to IAS 1 or the technical analysis in the tentative agenda decision provide an adequate basis for entities to determine how to classify loans with covenant conditions in all situations.

The examples covered in the tentative agenda decision all include covenant tests of working capital ratios. These metrics are assumed to be calculated at a point in time. However, we think the distinction between a condition that can be assessed at a point in time versus an accumulating condition (as explained in BC48E of IAS 1) is arbitrary. Therefore we do not consider the current guidance and agenda decision to give sufficient clarity over covenant tests, whether these should be assessed as at the point in time at the end of the reporting period or whether judgement can be applied to make adjustments to assess these as accumulating conditions. For example, we do not consider the guidance to be clear for the following covenants:

- covenants assessing financial performance over a cumulative period where the period is not coterminous with the end of the reporting period;
- covenants such as debt/equity ratios where the equity and debt components might be materially affected by the profit and cash flows respectively between reporting date and the compliance testing date; and

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- non-financial covenants which are tested after the end of the reporting period, for example the need to provide audited financial statements within a set period after the end of the reporting period.

The examples in the tentative agenda decision illustrate how non-compliance with covenants at test dates which are within twelve months of the end of the reporting period should be treated. We note that paragraph 72A of IAS 1 states *"The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date"*. This is not limited to tests which take place within twelve months of the end of the reporting period. We are unclear how covenant tests which take place more than twelve months after the end of the reporting period should be treated, and whether it is necessary for an entity to comply with the conditions of such tests as at the end of the reporting period in order for a loan to be classified as non-current.

We believe a lack of further guidance in these areas will lead to diversity.

Broader implications of the amendment

We have concerns that the impacts of the requirements will be more significant than the Board expected when finalising the amendments. This might result in common instances of debt being classified as current in situations when lenders do not have rights to recall the loans and where neither lenders nor reporters expect the loan to be classified as current. We consider this might result in statements of financial position providing a current / non-current classification which is not meaningful for investors and other stakeholders. We note that useful information on covenants is already provided elsewhere in the financial statements, for example in going concern or IFRS 7 liquidity risk disclosures. We note that IFRS 7 does not explicitly require disclosure of details of covenants as part of liquidity risk, however we are seeing an increasing number of corporates including these details of their covenants as part of these disclosures.

We also foresee practical challenges for entities and lenders resulting from the amendment. For example, if an entity would be required to classify a loan as current as a result of not meeting a covenant test which is legally tested at a future date. We consider it would be challenging for the entity to obtain a waiver for these potential future breaches before the end of the reporting period, when a legal breach of contractual terms has not occurred.

The comment period for this tentative agenda decision coincides with the peak financial reporting period for a significant proportion of preparers. We note that the Board made a decision to defer the effective date of this IAS 1 amendment. As a result, we think that there is sufficient time to perform additional outreach to ensure the potential impact and effects are aligned with the Board's current expectation. The Committee may wish to extend the comment period for this tentative agenda decision to ensure views from preparers, investors and lenders are appropriately included. Alternatively, we recommend that the Board carry out some targeted outreach with preparers and other stakeholders in order to confirm the impact and effect of the proposed changes.

pwc

If you have any questions in relation to this letter please do not hesitate to contact Henry Daubeney, PwC Global Chief Accountant and Head of Reporting (+447841569635).

Yours faithfully

Pricewaterhouse Coopers

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11 February 2021

Ms Sue Lloyd
Chair
IFRS Interpretations Committee
IFRS Foundation
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Via website: www.ifrs.org

Dear Sue

Tentative Agenda Decision – Classification of Debt with Covenants as Current or Non-current (IAS 1)

As the representatives of over 200,000 professional accountants in Australia, CPA Australia and Chartered Accountants Australia and New Zealand (CA ANZ) thank you for the opportunity to comment on the above Tentative Agenda Decision (TAD) of the IFRS Interpretations Committee (IFRIC).

CPA Australia and CA ANZ are concerned that the conclusion arrived at in Case 3 of the TAD may not reflect the outcomes that the amendments made to IAS 1 *Presentation of Financial Statements* (IAS 1), issued in January 2020, sought to achieve. We believe that, if the TAD interpretation is applied as proposed, this could result in inappropriate presentation that fails to mirror the economic substance of the loan agreements entities have entered into. We are also concerned that the TAD introduces a rules-based, rather than evidence based, approach to interpreting the amendments to IAS 1 that pre-empts the experience that will gained from practical application of these amendments ahead of their 1 January 2023 application date.

The reasons for our concerns are set out below:

Application of the requirements to Case 3
In Case 3 of the TAD, the fact pattern specifies that the entity is required to meet two specified conditions for the right to defer settlement of the liability by at least 12 months:

- a working capital ratio above 1.0 at 31 December 20X1 (the reporting period end); and
- a working capital ratio above 1.1 at 30 June 20X2 (6 months after the reporting period end)

The entity has a working capital ratio of 1.05 at 31 December 20X1.

Having considered the amendments to IAS 1, IFRIC concludes that the entity does not have the right to defer settlement of the liability for at least 12 months at the reporting period end. This is because it considers that the wording of IAS 1 requires the entity to comply with both the current and future working capital measures at the reporting period end.

We believe that, in reaching this conclusion, IFRIC has not adequately considered the context in which variable covenants may be imposed by lenders over time. Feedback received from our members is that such variability in covenants generally reflect an acknowledgement by the lender that different economic circumstances may be relevant at the later date (e.g. to allow for

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seasonal trading or an impending business restructure or acquisition). Variable covenant thresholds allow for these future circumstances, while still protecting the lender's interests.

Arriving at the classification of a loan as current, without adequately considering the conditions and intent behind the financial arrangement entered into, would appear to negate the substance of the underlying economic phenomenon and result in the imposition of restrictions to the entity's borrowing rights that are more onerous than the lender has chosen to allow.

We accept that management expectation that the entity will meet the specified condition at 30 June 20X2 is not enough to defer settlement for at least 12 months at the reporting period end. However, the rights of the borrower are, more importantly, subject to what the lender expects to occur between, and at, the two points in time. Feedback received from our members suggests that as long as the entity continues to perform consistently in line with future lender expectations, the rights of the entity in respect of the liability and its intended repayment remain unchanged from the lender's perspective.

Therefore, we do not believe that it is appropriate for an accounting standard (or an interpretation thereof) to place a more onerous condition on an entity's right to defer settlement of a liability, with its associated reporting consequences, than that placed on the entity by the lender itself.

We also consider that the interpretation of the wording of the revised paragraph 72A in IAS 1 to support the case 3 conclusion is inappropriate. This paragraph states that "*the entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date*". In our view, this particular requirement was introduced to address the common scenario where the financial information required to test the specified condition is not available until after the reporting period end (e.g. audited financial statements are often only available three to four months after the reporting period end). In such circumstances, the test of compliance will be carried out at a later date but using conditions existing at the end of the reporting period. Again, we do not agree that it is appropriate to use this clause as justification to include, at the reporting date, the effect of future events that the lender clearly expects both to exist, and then be tested for, at a later date.

Finally, we note that as part of the discussions by the International Accounting Standards Board (IASB) in arriving at the amendments to IAS 1' and the subsequent discussions by IFRIC that gave rise to the TAD, consideration was given to why lenders may place different conditions at different points in time, including seasonal fluctuations in business and major debt restructuring. However, we consider that a lack of reference to these considerations in the TAD is an important oversight in reasonably interpreting the new requirements of IAS 1.

Due process concerns

In addition to the above, we also have concerns about the due process followed by IFRIC on this issue. We note that a formal submission in respect of this matter has not been received but that the decision to discuss and issue a TAD has been based on informal feedback and enquiries received from stakeholders on how to apply the amendments to IAS 1. Given the deferral of the intended application date and the significance of the amendments to IAS 1 to many entities, this approach pre-empts the widespread practical application of the changes to IAS 1. It provides only minimal opportunity at this time for preparers and other stakeholders to consider the practical ramifications of the amendments to IAS 1. Accordingly, we request that IFRIC considers all the relevant facts and circumstances associated with a specific fact pattern presented to it of practical challenges faced by entities when they apply the amended requirements of IAS 1 in due course. Since IFRIC Agenda Decisions now have the same authority as the applicable IFRS due to modifications made to the IFRS Due Process Handbook, we suggest IFRIC needs to give more careful consideration to any potential unintended consequences that may arise from this TAD before it is finalised.

Referral to the IASB

It is possible that the IFRIC conclusions arrived at in the TAD represent a fair technical interpretation of the IASB's final amendments made to IAS 1 and issued in January 2020. However, if this is the case, we believe this potentially identifies an underlying problem with the implementation of these amendments. Although our stakeholders have been made aware of the revisions, many have only recently commenced considering the ramifications of the necessary changes to financial statements. The recent publication of IFRIC's preliminary conclusions in the TAD has raised concern amongst our stakeholders about how the revised IAS 1 should be interpreted and applied, not only to the examples discussed in the TAD, but to many other loan agreements with conditions attached.

We believe that there is a need for clearer direction on the issue of making current/non-current classification decisions when loans are subject to conditions and such direction needs to deal with both the variety of conditions that are imposed and the reasons why they are imposed and change over time. This direction should then be supported by a substantive education process undertaken with lenders and borrowers about the new requirements in IAS 1. As it stands, these new requirements appear to lead to a classification of many loans with conditions attached as current, a situation that we do not believe necessarily reflects the economic substance of the conditions being imposed by lenders, the rights granted to the borrower under such loan agreements, or indeed lender expectations in respect of such loans. We also note that paragraph 72A was not included in the public consultations predating the IAS 1 amendments and as a result we are concerned that insufficient opportunity has been provided to stakeholders to ensure the words used now provide the clarity stakeholders are seeking. Therefore, we recommend that our concerns be referred to the IASB for further consideration.

If you have any questions about our submission, please contact either Ram Subramanian (CPA Australia) at ram.subramanian@cpaaustralia.com.au or Amir Ghandar (CA ANZ) amir.ghandar@charteredaccountantsanz.com.

Your sincerely

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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)*

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

KPMG IFRG Limited

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.

ICAEW
REPRESENTATION 18/21

CLASSIFICATION OF DEBT WITH COVENANTS AS CURRENT OR NON-CURRENT (IAS 1)

Issued 11 February 2021

ICAEW welcomes the opportunity to comment on the IFRS Interpretation Committee's' tentative agenda decision regarding the classification of debt with covenants as current or non-current (IAS 1) published December 2020, a copy of which is available from this link.

This response of 11 February 2021 has been prepared by the ICAEW Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 156,000 chartered accountant members in over 149 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

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KEY POINTS

1. ICAEW welcomes the opportunity to comment on the IFRS Interpretation Committee's tentative agenda decision regarding the classification of debt with covenants as current or non-current (IAS 1).
2. We have reviewed the three case studies outlined in the tentative agenda decision and agree that based on the facts and circumstances provided in each scenario, the conclusions reached reflect the underlying requirements outlined in the recent amendments to IAS 1 *Presentation of Financial Statements.*
3. While we agree with how the amendments to IAS 1 have been interpreted, we are nevertheless concerned with the resulting conclusions. In particular, that the amendments would bring forward the possible non-compliance of future debt covenants into the current period, even when conditions have not been breached at the year end. In our view this outcome is at odds with the accruals basis of accounting, which paragraph 1.17 of the Conceptual Framework describes as depicting 'the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur…'.
4. The case studies also raise questions around how the amendments to IAS 1 would apply when debt covenants are set in accordance with the business cycle of a company which, for example, may be seasonal. In this case, the position at the year-end may not be a relevant or accurate indicator for future periods. For example, taking case study 3 of the tentative agenda decision, the working capital ratio at 31 December 20X1 meets the covenant at that date, but would not meet the future required covenant at 30 June 20X2, and therefore the debt is classified as current at 31 December 20X1. However, if the debt covenants have been set to reflect the seasonality of the business, the working capital ratio at the year-end might justifiably be very different at 30 June 20X2. In this situation the amendments appear to result in a counterintuitive conclusion.
5. The tentative agenda decision has thrown light on the practical implications of the amendments to IAS 1 and we understand that for many, the result is not what had been expected. Indeed, in our response to the IASB's original proposed amendments to IAS 1 (ED 2015/1) we expressed our view that, under the proposals, an expected future breach would not mean that an existing liability would be presented as current as at the reporting date. We also expressed a general concern over the clarity of the proposals and how this uncertainty might lead to confusion in practice.
6. We believe that the objective in the scenarios examined by the Interpretations Committee should be to communicate to users (i) that the entity is in compliance with its loan covenants at the balance sheet date, and (ii) the risk of possible non-compliance with those covenants in the future and the consequence for the entity if those covenants were breached. We think that the first of these objectives is best achieved through classification of the loan as non-current, and the second through disclosure about the entity's liquidity risks. We recognise that resolving our concerns is a matter for the IASB, rather than one for interpretation by the Interpretations Committee, and so we recommend that the Interpretations Committee refers this matter to the IASB for its further consideration.

THE 100 GROUP

Financial Reporting Committee

IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

10 February 2021

Dear Ms. Lloyd,

Thank you for the opportunity to respond to the IFRS Interpretations Committee's Tentative Agenda Decision on the Classification of Debt with Covenants as Current or Non-current (IAS 1).

This response has been prepared by the 100 Group Financial Reporting Committee and is intended to speak on behalf of the Group as a whole. The 100 Group membership represents around 87% of the FTSE100 market capitalisation as well as a number of equally significant sized unlisted businesses. We note that whilst this letter expresses the views of the 100 Group as a whole, these views are not necessarily those of individual members nor their respective employers. We thank you for the opportunity to comment on your proposal and are happy to have any follow up discussion if helpful.

While we do not disagree with how the amendments to IAS 1 have been interpreted, we have significant concerns about the resulting conclusions which, in our view, are counter intuitive and likely to have a detrimental impact on the market. Any changes to the International Accounting Standards should provide users of the financial statements with better and/or more transparent information regarding the performance of a company which, based on the Tentative Agenda Decision, we do not consider the amendments to IAS1 do.

Classifying debt based on a hypothetical test at the reporting date does not take into account the intended design of covenants and disconnects reporting of debt from its contractual terms and conditions. Doing so is likely to result in the classification of debt as current, suggesting that the company is not in compliance with the terms of the loan, when neither the company nor the lender expect a breach of covenants at the actual test date.

For example, seasonal businesses may not be expected to pass hypothetical covenant tests throughout the year. However, based on the tentative agenda decision they would be required to repeatedly re-classify debt between current and non-current at different reporting dates, irrelevant of whether an actual breach has occurred or is expected. We believe this would reduce the understandability and comparability of the resulting financial statements, particularly when biannual and quarterly financial statements are prepared.

A hypothetical test would also not take into account the mitigating actions, proactive covenant management or business planning exercises that a business can take. A company may plan to make divestments or to maintain working capital ratios, the example used by the Committee, a company can use factoring, offer early payment incentives to customers and defer payments to suppliers. Conversely, a company that expects to pass a covenant at the test date but that, if measured, would fail the test at the reporting date may enter into mitigating actions to avoid this hypothetical situation, increasing the level of accounting disclosure and incurring additional costs. It is important that changes to standards do not mean companies need to adapt their commercial operations solely for the purpose of year-end reporting.

Additionally, the Committee's Tentative Agenda Decision does not provide examples of non-financial covenants. Requiring companies to comply with all conditions that will be tested within 12 months of the reporting date, in order to classify its debt as non-current, is likely to cause further complications when these covenants are considered. For example, a common requirement is that companies file accounts with an unmodified audit opinion within a set time period of their year-end. It is also not uncommon for a company to have covenants with cross-default clauses with respect to other covenants. In these instances, a hypothetical covenant breach at the reporting date could give rise to an actual breach of other covenants, and the associated ramifications.

We also consider that the Tentative Agenda Decision would create inconsistency with almost all other accounting standards where projected financial information is applied in the determination of the measurement and presentation of assets and liabilities. Such inconsistency would further contribute to making the financial statements less understandable and comparable for users.

Users of the financial statements could, in our opinion, obtain a better understanding as to the 'health' of the company through additional disclosure (as opposed to reclassification of balances between non-current and current). Such disclosure would vary on the degree of estimation uncertainty as to whether a company is expected to pass the financial covenant at the test date. Where appropriate, this could lead to disclosure of significant estimation uncertainty if the covenant is not expected to pass at the test date or is dependent on a number of factors not fully within the control of the company or that the company has limited historical experience of achieving.

In our view, the fact that the amendments lead to the conclusions set out in the Tentative Agenda Decision raises questions about the appropriateness of the proposed amendments themselves.

We recommend that the IFRS Foundation conduct additional outreach with stakeholders, particularly preparers and lenders, to consider any other unintended consequences and that the Interpretations Committee add a standard setting project to the IASB's work plan to revisit the appropriateness of the amendments to IAS 1.

We hope you find that our observations helpful and insightful as you move forward. Please do contact our secretariat Hannah Maughan at secretariat@the100group.co.uk should you wish to discuss any of our comments in further detail and she will be very happy to put you in touch with us.

Yours sincerely,

Iain J Mackay,
Chair of the 100 Group Financial Reporting Committee

Deloitte.

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12 February 2021

Sue Lloyd
Chair
IFRS Interpretations Committee
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London
United Kingdom
E14 4HD

Dear Ms Lloyd

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

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the December 2020 IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on whether an entity has a right to defer settlement of a liability for at least 12 months after the reporting period when the right to defer is subject to specified conditions.

We believe that this issue is of such significance that it cannot be resolved by the Committee through an agenda decision. We strongly believe that the Board should reconsider the conclusion reached in the recent amendment to IAS 1 to ensure that it provides a principle that results in relevant classification of debt with covenants as current or non-current.

We are very concerned that the conclusion proposed in the tentative agenda will often result in a presentation of an entity's financial position that does not provide relevant information, especially for those entities that have cyclical or seasonal businesses or are emerging growth or start-up businesses.

If we consider Case 2 presented in the tentative agenda decision, as an example, in a cyclical business where receivables or inventory vary, the working capital ratio may be quite different at the reporting period end (31 December) compared to at the covenant testing date (31 March). If the entity reports on a quarterly basis, applying the rationale in the tentative agenda decision, the liability would be classified as current at December and as non-current at March. This regular movement in the classification of the liability between current and non-current will not provide useful information for users of the accounts. This is particularly the case since the lender may have established the covenant testing date at 31 March considering the cyclical nature of the business of the entity, with no expectation on the lender's part that the covenant would be met at another reporting date.

Similarly, consider Case 3 presented in the tentative agenda decision in the situation of a start-up business. As the borrower is expected to grow, the lender may specifically intend that the covenant criteria be lower in earlier periods. The lender may actually view these covenants as different tests based on different stages of the business's life. Applying the requirements of a later covenant applicable to a later stage of the borrower, albeit within 12 months, may not align with the lender's expectation.

We are concerned that it will be challenging for users to understand whether a reclassification of a debt as current is due to a theoretical breach of a future covenant or an actual breach at the reporting date. The implications of these two situations may be significantly different and the current Standard fails to differentiate between them.

Additionally, classification as current in the circumstances described in cases 2 and 3 may not provide relevant information about liabilities due to be repaid within 12 months from the reporting date and may be inconsistent with other disclosures, such as going concern. This could cause significant confusion amongst users.

For these reasons, therefore, we do not consider that it would be appropriate to finalise the agenda decision and we strongly suggest that further standard setting activity by the Board is required.

If the Committee were to finalise the decision, we would suggest that the rationale for the liability being classified as current in case 1 should be expanded. We agree that where a waiver is granted at the period end for three months, IAS 1:75 requires classification as current given that the period of grace related to the 31 December violation is less than twelve months. However, this does not appear to be the only reason why the liability would be presented as current. Applying the analysis presented in the tentative agenda decision, it appears that the requirements in IAS 1:72A also apply with respect to the subsequent quarterly testing and in this case would also result in classification of the liability as current. This is because at the end of the reporting period the entity does not comply with the specified condition at each of the testing dates during the next twelve months.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

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February 12, 2021

IFRS Foundation
Columbus Building
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London E14 4HD
UNITED KINGDOM

RE: Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

Dear Sir or Madam:

Cenovus Energy Inc. ("Cenovus") is responding to the IFRS Interpretations Committee's (the "Committee") tentative agenda decision, "*Classification of Debt with Covenants as Current or Non-current (IAS 1)"* (the "Tentative Agenda Decision"). We appreciate the opportunity to provide our comments.

Cenovus is one of Canada's leading integrated energy companies headquartered in Calgary, Alberta, and is listed on the Toronto and New York stock exchanges, with a market capitalization of approximately $17 billion. We report our financial results under International Financial Reporting Standards ("IFRS").

We were supportive of the clarification obtained in the amendment to IAS 1 with the issuance of "*Classification of Liabilities as Current or Non-current"* released in January 2020. However, in review of the Tentative Agenda Decision, we feel it is important to address our concerns with the accounting treatment that would be required under the current IFRS guidance with respect to classification of debt with covenants. We have provided responses to each fact pattern outlined in the Tentative Agenda Decision in the attached Appendix A.

The required accounting treatment that has been unveiled in the Tentative Agenda Decision for the described fact patterns causes concern as we do not agree with the potential outcomes, particularly the result of hypothetical covenant tests and the reclassification of long-term debt to current debt, despite attaining a waiver for the period in which a covenant is breached. We strongly recommend that the Committee proceed with the addition of a standard-setting project on this subject in order to address important considerations that are not yet addressed in current IFRS guidance.

We would like to thank the Committee for the opportunity to respond to the Tentative Agenda Decision.

Yours truly,

Neil W. Robertson

Neil W. Robertson
Senior Vice-President & Comptroller
Cenovus Energy Inc.

APPENDIX A

Case 1 – Fact Pattern
An entity has a loan with the following contractual terms: *a) the loan is repayable in five years (i.e. at 31 December 20X6).* *b) the loan includes a covenant that requires a working capital ratio above 1.0 at each 31 December, 31 March, 30 June and 30 September. The loan becomes repayable on demand if this ratio is not met at any of these testing dates.* *c) the entity's working capital ratio at 31 December 20X1 is 0.9 but the entity obtains a waiver before the reporting date with respect to the breach at that date. The waiver is for three months. Compliance with the covenant on the other testing dates continues to be required.* *d) the entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).*
Case 1 – Application of IAS 1 to the Fact Pattern
The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March, 30 June, 30 September and 31 December 20X2. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9. *The entity obtains a waiver from the lender, but the waiver is for only three months after the reporting period. Paragraph 75 of IAS 1 states that 'an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period'.* *Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.*

While we understand the IFRS guidance requiring a right to defer settlement for at least 12 months was a requirement of IAS 1 prior to the amendment released in January 2020, this fact pattern reveals accounting guidance that requires reexamination. We strongly disagree with the presentation of the loan as current in this fact pattern. Classification of the debt as current may be misleading given the terms and conditions of the loan agreement. Under the terms and conditions of the loan agreement, the loan should not be classified as current at December 31, 20x1 as the entity has obtained a waiver for the reporting period in question. As at December 31, 20x1, there is no triggering event in the loan agreement requiring repayment and as such, the accounting treatment should follow suit. The classification as current will create unnecessary concern and may be misleading to the users of the financial statements as the entity expects the covenant to be above the required ratio at the next testing date per the terms and conditions. This fact pattern illustrates a mismatch between the accounting classification as current in accordance with IFRS and the classification as current according to the contractual terms of the loan agreement. We recommend additional guidance in IFRS to support the alignment of accounting classification to contractual terms of the underlying agreements. We are supportive of the continuance of using note disclosure to identify that the covenant for a given reporting period has not been met as opposed to the reclassification of long-term debt to current debt. This will clearly and accurately inform financial statement users that the entity has not met a covenant test, has received a waiver and expects to be in compliance at the next covenant testing date.

Case 2 – Fact Pattern
The fact pattern is the same as Case 1 except: *a) instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at each 31 March (ie the ratio is tested only once a year at 31 March). The loan becomes repayable on demand if the ratio is not met at any testing date.* *b) the entity's working capital ratio at 31 December 20X1 is 0.9. The entity expects the working capital ratio to be above 1.0 at 31 March 20X2.*
Case 2 – Application of IAS 1 to the Fact Pattern
The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March 20X2. *Paragraph 72A of IAS 1 states that 'if the right to defer settlement is subject to the entity complying with specified conditions the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date'. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9.* *Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.*

In the above fact pattern, the classification of debt as current could create unnecessary concern about the financial performance of the entity. An entity may have numerous reasons for entering into an annual covenant compliance condition, which may include, but not be limited to, operating a business that is highly cyclical or in early stages of development. Requiring a business that has high fluctuations in operating results to satisfy a hypothetical test can easily result in the entity failing the test prematurely. Similar to Case 1, there is a mismatch between the accounting classification as current debt in accordance with IFRS and the classification as current debt in accordance with the contractual terms of the loan agreement, which may have been specifically entered into to allow for annual versus quarterly compliance testing. In addition, in this fact pattern the hypothetical test would require reclassification of the debt as current as at December 31, 20x1. Upon testing at the actual covenant test date of March 31, 20X2, the classification as current will negatively affect the working capital ratio, creating a higher probability of breaching the covenant on the actual test date. In addition, the classification of debt as current could have negative impacts on other ratios which include current liabilities, resulting in potential breaches of other covenants or contractual arrangements. Furthermore, relief may not be available if the hypothetical test is not met as waivers may not be provided for a hypothetical test breach. We believe the requirement of a hypothetical test could unfairly cause negative impacts to an entity that otherwise would not exist. We recommend removing the requirement of the hypothetical test as it does not align with the underlying agreement and may cause unwarranted concern to financial statement users.

Case 3 – Fact Pattern
The fact pattern is the same as Case 1 except: *a) instead of the condition described in Case 1, the covenant requires a working capital ratio above 1.0 at 31 December 20X1 and above 1.1 at 30 June 20X2 (and at each 30 June thereafter). The loan becomes repayable on demand if the ratio is not met at any of these testing dates.* *b) the entity's working capital ratio at 31 December 20X1 is 1.05. The entity expects the working capital ratio to be above 1.1 at 30 June 20X2.*

Case 3 – Application of IAS 1 to the Fact Pattern
The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with two specified conditions—a working capital ratio above 1.0 at 31 December 20X1 and a working capital ratio above 1.1 at 30 June 20X2. *Paragraph 72A of IAS 1 states that 'if the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date'. The entity has a working capital ratio of 1.05 at 31 December 20X1. Therefore the entity complies with the condition tested at that date (a working capital ratio above 1.0) but does not comply with the condition that will be tested at 30 June 20X2 (a working capital ratio above 1.1).* *Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.*

We believe the fact pattern above will create confusion to users of the financial statements through reclassification from long-term debt to current debt when an entity is in compliance with the underlying agreement at the reporting date. In addition, and consistent with Cases 1 and 2, the mismatch between the accounting classification as current in accordance with IFRS and the classification as current in accordance with the contractual terms of the loan agreement is concerning. In this fact pattern, the entity expects to be in compliance with all covenants at each testing date under the terms and conditions of the loan agreement. However, the IFRS guidance as currently written will require classification of the debt as current until the new covenant ratio is met. In our view, accounting for an entity's operations should reflect the terms and conditions agreed to in order to give a fair representation of financial results. Creating a mismatch between the presentation and the underlying loan agreement will cause confusion and may mislead users of the financial statements. In addition, our concerns identified in Case 2 with respect to cyclical entities and entities in certain stages of development are relevant in this fact pattern as well because many businesses may struggle to meet these hypothetical tests. Our concerns can be addressed by aligning the entity's balance sheet presentation to the terms and conditions of the underlying loan agreement with consideration to requiring additional note disclosure to provide clarity on certain terms of the agreement, such as any future covenants over the course of the loan agreement.

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Ms Sue Lloyd
Chair of the IFRS IC

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February 12, 2021

REF: Classification of Debt with Covenants as Current or Non-current (IAS 1)

The Office of the Chief Accountant of the Securities and Exchange Commission of Brazil – CVM welcomes the opportunity to respond to the TAD Classification of Debt with Covenants as Current or Non-current (IAS 1)

We are a division of the national securities regulator engaged in the study, development, interpretation and guidance of accounting standards for Brazilian listed companies and investment funds. By endorsement of CVM, the accounting standards issued by Brazilian Accounting Pronouncements Committee – CPC become mandatory for public companies. In relation to investment funds, the accounting standards issued by CVM are mostly aligned with IFRS standards.

One of the legal mandates of CVM is to stimulate savings and application in securities through the efficient and regular functioning of capital markets. To stimulate permanent investment in shares of publicly held companies and investment funds we are convinced that a good quality set of accounting standards play a central role in achieving these objectives.

If you have any questions about our comments, please do not hesitate to contact us at snormas@cvm.gov.br

General Comments

We acknowledge that the conclusions drafted in the TAD for the three situations presented are in accordance with paragraphs 69 (d), 72A and 75A of IAS 1, as amended in January, 2020. Nevertheless, we are concerned that the application of the referred paragraphs may not portrait a faithful representation of an entity financial position, nor provide useful information for decision making, especially in jurisdictions where creditors do not usually impose the anticipated liquidation of liabilities due to breaches of covenants.

In our understanding, the provisions of the aforementioned paragraphs seem to disregard the particularities of the economic environment where the transactions have taken place and do not allow judgements made by management based on reasonable and supportable evidence available about creditors' intention or desire to anticipate the liquidation of the referred obligation (this situation could impair the predictive value of financial statements). In our jurisdiction, for example, covenant breaches we have observed resulted in renegotiations and waivers. In other words, in practice, such observed breaches did not trigger the early liquidation of liabilities. We also observed that IAS 1 (as amended in January, 2020) has a different conceptual approach when compared to other standards that allow the use of management expectations and judgements, such as IAS 37 (measurement of provisions), IFRS 5 (held-for-sale assets), IAS 1 (going concern analysis), IAS 36 (impairment testing) and IFRS 13 (fair value measurement). We did not see in the Basis for Conclusion any explanation or justification for the use of a different approach in IAS 1. We find this lack of consistency undesirable.

Moreover, paragraph 72A appears to override contractual arrangements by anticipating covenant testing dates to the reporting date. If testing dates are contractually set in a period different from the reporting date, it is probably done for an economic reason. For example, the parties may want to work with progressive targets, such as in case 3 of the TAD. As another example, some businesses may involve very high volatility on numbers due to seasonality (e.g.: agriculture and tourism sectors). In this context, we are concerned that paragraph 72A, when effective, might have the unintended consequence of misleading users by making companies reclassifying liabilities to current and, sometime later, reclassifying them back to non-current. In order to avoid this inconsistency, but still provide timely information on covenants, the IASB should work on improving covenants disclosures in the notes. For example, the standard could require the disclosure of the management perspectives (supported on objective evidences) on whether it will be able to meet its covenants at the testing dates, the expected practical effects of not meeting them and the efforts in place for a renegotiation, if any.

In fact, we believe that IAS 1 should allow management to apply judgement when deciding whether to reclassify the liability to current (in case of a covenant breach), requiring the disclosure in the notes the judgements and expectations used, supported by reasonable and objective evidence (especially about creditor's willingness to waive the breach).

We did not recall the proposition of paragraph 72A in the Exposure Draft when it went public in 2015 (ED/2015/1). This situation made CVM's technical staff members aware of new concerns, some of them we did not have the opportunity to express when the ED was first published. IAS 1 (as amended in January, 2020) might have the unintended consequence of not appropriately depicting an entity financial position, as conclusions drafted in the TAD show. In our understanding, such inconsistencies will require a standard-setting response.

Finally, we respectfully disagree with the inclusion of paragraph 72A in IAS 1, without having the proposal re-exposed to public consultation. In our best understanding, the ED (ED/2015/1) did not propose the requirement of fulfilling all next year`s covenant testing targets at the reporting date. In our opinion, such extreme provision should have been object of public debate.

For all these reasons, we kindly ask the IFRS IC not finalize the TAD and refer the matter to the IASB Board for redeliberation.

Yours sincerely,
Paulo Roberto Gonçalves Ferreira
Chief Accountant

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ASBJ FASF

15 February 2021

Ms. Sue Lloyd
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Comments on the Tentative Agenda Decision Relating to Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)

1. The Accounting Standards Board of Japan (the "ASBJ" or "we") welcome the opportunity to comment on the IFRS Interpretation Committee (the "Committee")'s tentative agenda decision relating to "Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)" in the December 2020 IFRIC Update.

Cases in the tentative agenda decision

2. We do not disagree with the conclusions for Case 1 and 2 in the tentative agenda decision. However, we have concerns with the analysis and the conclusion for Case 3.

3. Regarding Case 3, our understanding is that the entity is required to classify the debt as current for the following reasons:

   (a) the entity does not comply with the condition of the covenants concerning the future financial position at the end of the reporting period, even when the entity complies with the condition of the covenants tested at the end of the reporting period; and

   (b) paragraph BC48E in the Basis for Conclusions of IAS 1 is not relevant for the financial position.

4. In Case 3, the same condition does not continue to apply; rather, the conditions become stricter for the borrower with the passage of time. We believe that such conditions are set with the expectation that the borrower's business has seasonality or that the financial position of the borrower will improve over time. Accordingly, making judgements based on the condition as of the end of the reporting period would not necessarily faithfully represent such circumstances.

5. Paragraph BC48E in the Basis for Conclusions of IAS 1 states that an entity's financial performance for a period extending beyond the reporting period needs be adjusted, but the IASB decided not to specify a method of adjustment. It seems inconsistent not to allow an entity to adjust the financial position for a period extending beyond the reporting period, such as in Case 3 in the tentative agenda decision. The financial position of an entity represents a state at a certain point in time, but it can also be understood as an accumulation of financial performance. Accordingly, we think these treatments should be consistent. We are also concerned with distinguishing between the treatment for financial position and financial performance because, depending on how the terms and conditions are worded, the classification as current or non-current may differ and thus may impair the of comparability among entities.

Due process related to this tentative agenda decision

6. We have concerns with the due process related to this tentative agenda decision. Specifically, we question the transparency of the process when the secretariat of the Committee addresses issues for which it has not received official submissions, as in this case.

7. Paragraph 8.2 of the Due Process Handbook, as revised in August 2020, states that (Underline added by the ASBJ):

If the Interpretations Committee decides that a standard-setting project should not be added to the work plan <u>to address a question submitted</u> (see paragraphs 5.13–5.19), it explains why in a tentative agenda decision in IFRIC Update and on the IFRS Foundation website.

8. It is unclear whether the statement in paragraph 8.2 of the Due Process Handbook

would always requires questions to be submitted as requests to the Committee as a precondition to be considered by the Committee. However, when the secretariat of the Committee considers issues for which it has not officially received submissions, such as in this case, and drafts tentative agenda decisions, it may appear as if the secretariat of the Committee is selectively drafting tentative agenda decisions, which may raise questions about the transparency of the decision-making process regarding the issues addressed by the Committee.

9. Therefore, we believe that the Committee should make it a rule to address issues for which it has received submissions from external parties. In the rare circumstances where the Committee decides to address issues for which it has not received submissions from external parties, it should establish procedures to ensure the transparency leading to such decision.

10. We hope that our comments are helpful for the Committee's and the IASB's consideration in the future. If you have any questions, please feel free to contact us.

Yours sincerely,

A. Kogasaka

Atsushi Kogasaka
Chair

Accounting Standards Board of Japan

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15 February 2021

Ms Sue Lloyd
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Dear Ms. Lloyd,

Tentative Agenda Decision and comment letters: Classification of Debt with Covenants as Current or Non-current (IAS 1)

We welcome the opportunity to comment on the Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1).

We believe that classifying debt based on a forecast or theoretical covenant assessment, rather than a contractual testing date or the balance sheet date, may make the financial statements misleading to the user of those financial statements.

The crop protection and seed technology industries, similar to other global agriculture industries are cyclical in nature. Each year, during the low season months, our industry builds working capital (e.g. inventory) to ensure demand during peak cropping periods can be satisfied.

As a result of this annual working capital cycle, the fluctuation in our net debt can deliver a swing of up to 1.5x – 2.0x turns of leverage[1].

These seasonal fluctuations are recognised by our lenders, such that we have established seasonal financial covenants tailored to accommodate this fluctuation.

Certain of our debt facilities include consolidated leverage covenants with quarterly compliance requirements. The setting of the consolidated leverage covenant varies between quarters recognising the seasonality of our business. We understand that this is consistent with other global agriculture companies who maintain similarly structured debt facilities.

Under the Tentative Agenda Decision (TAD) the classification of debt is dependent upon a hypothetical covenant test. This is inconsistent with the contractual arrangements.

Example: Debt facility with maturity date in 5 years, and seasonal leverage covenants[2].

	Interim reporting date	Annual reporting date
Covenant	4.0x	2.0x
Actual outcome, per debt facility	2.5x (in compliance)	1.0x (in compliance)
Financial statements under TAD	Current	Non-current
Lenders perspective	Non-current	Non-current

[1] Leverage is typically measured as a ratio of net debt to annualised earnings before interest, tax, depreciation and amortisation.
[2] Covenant levels presented are hypothetical.

As is illustrated in the example above, the TAD essentially disregards the agreements made between the borrower (ourselves) and the lender, in which there is an understanding of the seasonal nature of the operations. In the example above, under the TAD we would be required to present our debt at the Interim Reporting Date as “Current”, while at the Annual Reporting Date the debt would be classified as “Non-Current”.

In the example, given the satisfaction of the compliance requirement at the interim reporting date, the lender does not have the contractual right to demand payment. We believe, using the example above, that a requirement to classify the debt as “Current” at our Interim Reporting Date when there is no requirement or intention to repay the debt within the next 12 months will mislead users of our financial statements.

As a result we request that further consideration of this TAD is undertaken to fully consider the consequences on companies that operate within seasonal industries and have arrangements that reflect these conditions.

We would welcome the opportunity to discuss this matter further with you.

Paul Townsend

Chief Financial Officer

About Nufarm

We are a leading crop protection and seed technologies company. We develop, manufacture and sell a wide range of crop protection products. We also have a proprietary seed technology business with global coverage. We sell our products in most of the world’s major agricultural regions. We are listed on the Australian Securities Exchange.

BUSINESSEUROPE

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15 February 2021

Dear Member of the IFRS Interpretations Committee,

Re: Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

We are writing to express our concerns with some of the tentative conclusions reached by the IFRS Interpretations Committee (the Committee) in the Tentative Agenda Decision *Classification of Debt with Covenants as Current or Non-current (IAS 1)* (the TAD). We disagree with the TAD as proposed by the Committee and think that it is necessary for the IASB to confirm its intentions with respect to the way paragraph 69(d) is applied.

In our view, the source of the difficulty in applying the relevant requirements of IAS 1 may be found in paragraph 72A which we believe was added to the amendments after the completion of the exposure process for the proposals. The issue resolves around the final sentence in this paragraph, that is, "The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date". The question that is raised is what constitutes the condition(s) and what is a compliance test.

To take the example of Case 2 in the TAD, the Committee has concluded that the "conditions" are that the working capital ratio should be more than 1.0 at <u>all</u> period ends throughout the financial year and that the 31 March is only a date when a compliance test should be carried out. We think that this interpretation confuses the condition and the date of testing and makes assumptions about the parties' intentions which may not be valid. Furthermore, this interpretation condemns the entity to test its working capital ratio at all period ends (which may differ according to the requirements of the jurisdiction).

Another, and we think more reasonable interpretation, is that the parties intended that the condition should be that at the 31 March the working capital ratio should be above 1.0. Clearly, for that condition to be effective, compliance with it must be tested <u>as of</u> that date. It can be argued that the condition itself does not have substance or create a legal obligation at any other date and that at those other dates it serves merely as an indicator. An example of a contract intended to have such an application would be to help with entities with activities of a cyclical nature in respect of cash flows, such as in certain retail activities where sales and hence cash inflows are very much seasonal.

For similar reasons we think that the Committee has come to a contestable conclusion about Case 3.

Finally, the cases discussed in the TAD are examples of contracts which are legally binding. In neither case 2 nor 3 could the entity be considered to have contravened the conditions of its contract with the lender and settlement could not be legally enforced. In addition, the substance of the contract would not cause the entity to settle the obligation in these circumstances. We therefore think that the TAD is in contradiction with both the both the legal and economic effect of the contract and that it would not result in a faithful representation of the agreements.

We therefore disagree with the Committee's tentative decision not to proceed to standard-setting activity, and we note that the date of mandatory application of the Amendments under review is "periods beginning after 1 January 2022", thus giving the IASB sufficient time, in our view, to clarify its intentions in this area.

Yours sincerely,

Erik Berggren
Senior Adviser

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15 February 2021

Subject: Tentative Agenda Decision— Classification of Debt with Covenants as Current or Non-current (IAS 1)

Dear IFRS Interpretations Committee:

On behalf of the International Air Transport Association's ("IATA") Industry Accounting Working Group ("IAWG"), we are writing to comment on the Tentative Agenda Decision—Classification of Debt with Covenants as Current or Non-current (IAS 1)
December 15, 2020.

IAWG is made up of senior finance professionals of major airlines and represents over 290 IATA member airlines.

IAWG does not agree with the accounting treatment provided for cases 2 and 3 in the tentative agenda decision based on the language of the existing standard for the reasons explained in this submission. We do not believe that the standard requires, or should require, a loan covenant that has not been breached at the reporting date to be considered in determining whether the liability is current as the reporting entity has the right to avoid being in breach prior to the measurement date where a breach will be determined and the liability made payable on demand.

IAWG does not agree that the principles and requirements in the existing standards provide an adequate basis for an entity to determine its accounting for the scenarios illustrated in the tentative agenda decision. We acknowledge that this section of IAS 1 was exposed and recently revised. The exposure draft did not reflect similar wording as the issued standard, particularly paragraph 72A. For the reasons explained in this submission, we strongly encourage the Board to re-expose this section of IAS 1 for respondents to make a knowing response regarding the intentions of the Board regarding the appropriate accounting treatment.

If you would like to discuss our comments further, please do not hesitate to contact Thomas Egan, IAWG Accounting Technical Expert at egant@iata.org.

Yours sincerely,

Thomas Stellpflug Chairman IATA IAWG	Donal Cahalan Vice-Chairman IATA IAWG

The Committee discussed three fact patterns with a loan that requires an entity to maintain a particular working capital ratio. In all fact patterns, the entity is assessing whether it classifies the loan as current or non-current at the end of an annual reporting period, 31 December 20X1). It is assumed that the criteria in paragraph 69(a)–(c) of IAS 1 are not met.

Case 1

The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March, 30 June, 30 September, and 31 December 20X2. The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9. As a result, the loan is payable on demand.

The entity obtains a waiver from the lender, but the waiver is for only three months after the reporting period. Paragraph 75 of IAS 1 states that 'an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period'.

Accordingly, the Committee concluded that the liability is payable on demand and the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

IAWG fully agrees with this assessment, that the treatment reflects the economic reality of the transaction and that the standard is clear regarding the treatment.

Case 2

The entity has not breached any condition at the reporting date and therefore the liability is not due on demand. Its working capital ratio is 0.9 at the reporting date. The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with a specified condition—a working capital ratio above 1.0 at 31 March 20X2.

Paragraph 72A of IAS 1 states that 'if the right to defer settlement is subject to the entity complying with specified conditions the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date'.

Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period because its working capital ratio is 0.9 at the reporting date.

IAWG does not agree. We believe that the need for a right to defer settlement is only relevant if the liability is due within the next 12 months. In this case the liability is not due within the next 12 months.

Even if IAS 1 is read to require a right to defer payment when a liability is not due in the next 12 months, the entity has until the compliance date of 31 March 20X2 to achieve compliance. That is a right to defer settlement for at least 12 months present at the reporting date as they have many options available to improve that ratio to comply by the compliance date. That right is not negated because the entity currently has not achieved compliance with a future condition.

IAWG does not read paragraph 72A as requiring that all conditions present over the next 12 months be complied with on the reporting date. We read this to mean that breach of a condition on that date is not impacted by when the breach will be measured for compliance. For example, if the loan covenants are measured when the audited accounts are filed. The issue is whether the entity complied at the reporting date and not when the breach would be assessed by the lender. If the standard is applied in the manner concluded by the Committee, we foresee issues with regard to seasonality where conditions vary and loan covenants are set over the year to reflect these variations and covenants that are set to reflect future expectations of performance based on the capital being provided by the lender. It is our view that the only relevant conditions at the reporting date are those that the entity must comply with at the reporting date as that was the intent of the entity and the lender. To interpret the standard as the Committee has overrides these intentions and therefore does not reflect economic reality.

IAWG notes that while paragraph BC48E is not part of the standards, it indicates that the Board considered whether to specify how management assesses an entity's compliance with a condition relating to the entity's cumulative financial performance (for example, profit) for a period extending beyond the reporting period. This would suggest the Board addressed the issue a reporting entity assessing compliance with future reporting requirements. The paragraph goes on to state that 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. That strongly suggests that the Board rejected the need to assess compliance with future reporting requirements as it would not provide useful information. IAWG would concur for the reasons stated above and find the Committee's conclusions on case 2 and case 3 inconsistent with the Board's position.

IAWG believes the standard should be amended to clarify the appropriate treatment.

Case 3

The entity's right to defer settlement of the loan for at least twelve months after the reporting period is subject to the entity complying with two specified conditions—a working capital ratio above 1.0 at 31 December 20X1 and a working capital ratio above 1.1 at 30 June 20X2.

The entity has a working capital ratio of 1.05 at 31 December 20X1. Therefore, the entity complies with the condition tested at that date (a working capital ratio above 1.0) but does not comply with the condition that will be tested at 30 June 20X2 (a working capital ratio above 1.1).

Accordingly, the Committee concluded that the entity does not have the right at the end of the reporting period to defer settlement of the loan for at least twelve months after the reporting period.

IAWG disagrees for the same reasons as outlined above for case 2. The liability is not due within the next 12 months at the reporting date therefore there is need for a right to defer payment, but even if there were, the entity has a right to act to comply prior to the 30 June 20X2 measurement date.

As explained above, IAWG does not agree that the principles and requirements in the existing standards provide an adequate basis for an entity to determine its accounting for the scenarios illustrated in the tentative agenda decision and strongly encourage the Board to re-expose this section of IAS 1 in order for respondents to making a knowing response with regard to the classification of liabilities subject to future conditions and for the Board to clarify the language in the standard to reflect their intentions.

IAWG would also like to call attention to the structure of paragraph 69 of IAS 1 that states the principle for classification of liabilities:

An entity shall classify a liability as current when:
a) it expects to settle the liability in its normal operating cycle;
b) it holds the liability primarily for the purpose of trading;
c) the liability is due to be settled within twelve months after the reporting period; or
d) it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

An entity shall classify all other liabilities as non-current.

This structure indicates that if any of the four conditions are met the liability must be classified as current. Yet, if a liability is due to be settled within twelve months of the reporting date and there is a right at the end of the reporting period to defer settlement for at least twelve months from that date it would be shown as non-current as explained in case 1 of this tentative agenda decision. In this case paragraph 69(c) is met requiring classification as current, but paragraph 69(d) negates this condition. That indicates that the two sentences are to be applied together and that the structure should be as follows:

An entity shall classify a liability as current when:
a) it expects to settle the liability in its normal operating cycle;
b) it holds the liability primarily for the purpose of trading; or
c) the liability is due to be settled within twelve months after the reporting period; and it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.

An entity shall classify all other liabilities as non-current.

IAWG would also like to call attention to paragraph 69(a) where the word "expects" is used and paragraph 75A, where the standard states if a liability meets the criteria in paragraph 69 for classification as non-current, it is classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period. We believe that the Board may have intended for paragraph 75A to only address paragraph 69(c) as paragraph 69(a) clearly is based on management's intent or expectations.

IAWG believes that management's intention or expectation to settle the liability is relevant as this information is used to estimate the cash outflows for the next period and clearly such settlements would meet the criteria in paragraph 69(a). The Board should make this part of the re-exposure of the amendment to IAS 1 and align the language to either apply management's intentions and expectations in relation to the settlement of liabilities to the classification of liabilities or not in all cases.

OICU-IOSCO

International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores
المنظمة الدولية لهيئات الأوراق المالية

February 15, 2021

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RE: Tentative Agenda Decision - Classification of Debt with Covenants as Current or Non-current

Dear Ms. Lloyd,

The International Organization of Securities Commissions (IOSCO) Committee on Issuer Accounting, Auditing and Disclosure (Committee 1) thanks you for the opportunity to provide our comments on the IFRS Interpretations Committee (IFRS IC) tentative agenda decision, *Classification of Debt with Covenants as Current or Non-current* (TAD).

IOSCO is committed to promoting the integrity of the international markets through promotion of high-quality accounting standards, including rigorous application and enforcement. Members of Committee 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect the general consensus among the members of Committee 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

Consistency with IAS 1 *Presentation of Financial Statements* (IAS 1)

Overall, we believe the TAD is a technically correct application of the amendments to IAS 1[1] and the examples within the TAD are helpful in supporting consistent application.

However, the TAD has made many members aware of new concerns, not previously appreciated during the Exposure Draft (ED/2015/1) process, that were not expressed in our Comment Letter dated June 15, 2015. Although a few members continue to agree with the amendments to IAS 1, many members question

[1] In January 2020 the International Accounting Standards Board (Board) issued *Classification of Liabilities as Current or Non-current*, which amended IAS 1 *Presentation of Financial Statements* and clarified how to classify debt and other financial liabilities as current or non-current.

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the usefulness of information that results from application of the amendments, particularly in certain situations as illustrated in the TAD. These members have identified certain aspects of the TAD that have raised concerns that may require a standard-setting response, including potential additional disclosures.

Differences in Approach within IAS 1 for Financial Position Covenants vs Other Covenants

Many members observe a significant difference between IAS 1.72A, which restricts the ability to consider management's expectations, with IAS 1.BC48E[2], which suggests that some form of adjustment to include expectations about cumulative financial performance / future transactions. Specifically, to these members, it appears the amendments (and the TAD appears to confirm) draw a distinction between how financial position covenants are evaluated (which do not permit consideration of management judgement, intentions, or expectations) versus financial performance and cashflow covenants (which appear to permit consideration of expectations). These members observe that the amendments to IAS 1 do not sufficiently explain the basis for such distinction (i.e., difference in approach) and believe the TAD could be expanded to explain the reasoning for this difference.

Although a few members acknowledge that limiting management expectations can mitigate against the risk of overly optimistic management expectations and assumptions and support consistent auditability and enforcement, many other members are not persuaded that these benefits are sufficient to outweigh the need to address the identified difference in approach. Specifically, many members believe that this difference should be addressed through standard-setting to permit consideration of expectations and support consistency across financial performance and cash flow covenants with financial position covenants (and any other potential covenants).

Use of Judgement in other IFRS Standards

Many members observe that the IAS 1.72A prohibition on incorporating management expectations differs from other IFRS Standards, that permit or require such incorporation, for example:

- IFRS 5 (held-for-sale analysis)
- IAS 1 (going concern analysis)
- IAS 19 (short-term employee benefits definition)
- IAS 36 (impairment testing)
- IAS 37 (measurement of provisions)

[2] It is acknowledged that Basis for Conclusion is not part of the Standard and does not contain official requirements. Nevertheless, we understand that many stakeholders do look to the Basis for Conclusions for additional guidance and insight.

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These members believe that consistency in approach among standards is important. The use of estimates and judgements is acknowledged to be a fundamental part of financial reporting. However, some members observe that classifying debt as current versus non-current is often more an objective process compared to most of the other examples above.

Expansion of the IFRS IC Process

Members noted that this issue did not appear to come to the IFRS IC through the usual inquiry submission process by a stakeholder. Nevertheless, similar to how the IASB has used Transition Resource Groups (TRGs), we believe it can be helpful when issues are identified prior to a standard or amendment's effective date and brought to an open forum, such as the IFRS IC, for a discussion and clarification on the application of the standard or amendment as this can support consistent application of the standard or amendment once it is effective.

We understand that for issues brought to TRGs there is extensive outreach with stakeholders in advance of any discussion. Since we are unable to clearly track the origin of the inputs to the TAD, we are unclear whether such outreach has occurred for this issue, in particular with lenders and borrowers. Considering the potential significance of this issue to a wide array of constituents, we believe additional formal outreach would be a useful step in the process to determine whether there are other related issues before finalizing the TAD.

Useful of Information

Many members observe that the usefulness of information produced by the amendments to IAS 1 could be diminished in certain circumstances because, for example, of:

- *Volatility of classification* – the potential for liability classification to flip between current and non-current for interim reporting periods (because of passing and failing the covenant from period-to-period due to seasonality, for example), when actual testing is only performed on specific dates (e.g., once or twice a year);
- *Hypothetical covenant testing* – hypothetical testing for financial reporting purposes at a date different than testing for actual loan agreement compliance purposes[3];

[3] For example, in Case 2 of the TAD, where the covenant is only tested at March 31, the accounting standards are establishing the need to test at December 31, even though the lender itself did not design the test to be done at that time. Thus, the accounting requirement is seen by some as negating the will of the parties to the loan agreement and what they agreed to with respect to the timing of the test.

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Although a few members continue to support the amendments to IAS 1, most members believe that some form of standard-setting is needed in the short-term. We intend to reiterate this view when responding to the broader Agenda Consultation.

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We appreciate your thoughtful consideration of the views provided in this letter.

If you have any questions or need additional information, please do not hesitate to contact Cameron McInnis, Chair of the Accounting Subcommittee of Committee 1 at +1 416-593-3675 or myself. In case of any written communication, please mark a copy to me.

Yours sincerely,

Makoto Sonoda

Chair
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Document No.101
February 15, 2021

To the IFRS Interpretations Committee,

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

Comments on Tentative Agenda Decision: "Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements)"

The following are the comments from the Accounting & Tax Committee of Japan Foreign Trade Council (JFTC) regarding the Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements). JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members, while the principal function of its Accounting & Tax Committee is to respond to developments in Japanese and international accounting standards. (Member companies of JFTC Accounting & Tax Committee are listed at the end of this document.)

Our comments

We do not agree with the IFRIC tentative agenda decision. Specifically, we strongly oppose classifying the loan as current or non-current based on covenants to be complied with at future testing dates, as in Cases 2 and 3 of the agenda paper. This would not faithfully reflect an entity's actual situation, reducing the utility of financial reporting, and thereby impairing the provision of useful information to users of financial statements.

Saying that an entity has the right to defer settlement for at least twelve months is essentially the same as saying that a lender has no grounds to require repayment on demand for at least twelve months. In both Case 2 and Case 3 of the agenda paper, at the reporting date the entity is either not required to comply with any covenant pursuant to the loan agreement, or it has already complied with the covenant. Accordingly, the lender has no grounds to require repayment on demand, making the only valid repayment date December 31, 20X6; the interpretation that the entity does not have the right to defer settlement for twelve months is therefore mistaken.

As in Case 2, if an entity classifies the loan as current or non-current based on covenants to be complied with at future testing dates and reflected this in its financial statements on reporting dates, it is envisaged that frequent reclassifications of the same liability between current and non-current could occur.

Moreover, as in Case 3, if an entity was required to comply with different numerical conditions at future dates, it is likely that, as a condition of the loan, the lender would regularly review for appropriate business growth based on the business plan provided to it. In that case it would be extremely unreasonable to determine the right to defer settlement by applying conditions predicated on such future business growth to the entity's financial position as of the reporting date.

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Sojitz Corporation
Sumitomo Corporation
Toyota Tsusho Corporation
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15 February 2021

Ms. Sue Lloyd
Chair
IFRS Interpretations Committee
Columbus Building
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Dear Ms. Lloyd,

IFRS Interpretations Committee Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)

The Malaysian Accounting Standards Board (MASB) welcomes the opportunity to provide comments on the above Tentative Agenda Decision published in December 2020.

The MASB thinks that the IFRS Interpretations Committee's conclusions on application of paragraph 72A of IAS 1 *Presentation of Financial Statements* to Case 3 in the Tentative Agenda Decision are unduly rigid because the entity complies with the loan conditions at its reporting date.

The MASB urges the Committee not to issue the Tentative Agenda Decision, and instead refer this matter to the IASB to provide further clarity on paragraph 72A of IAS 1. The MASB is concerned that the content of the Tentative Agenda Decision could have a significant impact on the classification of common loan agreements, resulting in long-term loans being reclassified as current even when this does not represent the business reality. We also note that paragraph 72A was not included in ED/2015/1 *Classification of Liabilities* (Proposed Amendments to IAS 1) and so has not been formally exposed for public comment. Therefore, the MASB suggests the IASB considers both the drafting of paragraph 72A and the implications of the Committee's conclusions that we have described below.

Our interpretation of paragraph 72A

Paragraph 69(d) of IAS 1 specifies that an entity classifies a liability as current when 'it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period'. Paragraph 72A of IAS 1 provides related application requirements.

Paragraph 72A of IAS 1 states 'If the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period'. In Case 3 in the Tentative Agenda Decision, the entity meets the working capital ratio requirement at the end of the reporting period (31 December 20X1) and is not in breach of any loan conditions at this date. Consequently, we consider that the entity complies with the loan conditions at the end of the reporting period. Paragraph 72A does **not** specify that the entity must comply with loan conditions *at a subsequent date*.

Paragraph 72A of IAS 1 also states 'The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date'. Our existing understanding of the purpose of this sentence was to address the common scenario when the lender tests compliance at a future date based on the entity's financial situation as at the reporting date. For example, a lender may test compliance with a covenant based on the entity's financial statements for the year ended 31 December 20X1 only at the time those financial statements are issued, for example, in March 20X2. However, the Tentative Agenda Decision appears to interpret this sentence more broadly as—'The entity must comply with the conditions at the end of the reporting period even if the lender does not require compliance until a later date'. We do not read paragraph 72A that way.

Given our comments above, we do not think the Committee's conclusions in the Tentative Agenda Decision represent the only possible interpretation of paragraph 72A of IAS 1.

Conclusions appear unduly rigid

The MASB observes that, besides adding paragraph 72A, *Classification of Liabilities as Current or Non-current* (IAS 1 amendments) removed the word 'unconditional' from paragraph 69(d).

Paragraph BC48D of IAS 1 clarifies the Board's reasons for this as 'The Board noted that rights to defer settlement of a loan are rarely unconditional—they are often conditional on compliance with covenants. The Board decided that if an entity's right to defer settlement of a liability is subject to the entity complying with specified conditions, the entity has a right to defer settlement of the liability at the end of the reporting period if it complies with those conditions at that date'.

The Committee's conclusions appear to contradict removal of the word 'unconditional'. Our understanding was this amendment was intended to widen, rather than narrow, application of paragraph 69(d) to cater for rights subject to conditions, provided the entity complies with those conditions at the reporting date.

The MASB also considers that the Committee's interpretation that paragraph 72A requires an assessment of *future* covenants based on the entity's *current* financial position would result in 'comparing apples with pears' and that this seems an unduly rigid approach compared with other Standards. For example:

(a) Other IFRS Standards require consideration of the entity's future expectations, for example, when determining expected credit losses in IFRS 9 *Financial Instruments* and expected future cash flows in IAS 36 *Impairment of Assets*.

(b) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires only obligations arising from past events existing independently of an entity's future actions to be recognised as provisions. If an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.[1] An entity can usually avoid breaching a future covenant by making changes to its operations.

Implications for the reporting of common loan agreements

The MASB has particular concerns regarding the outcome of Case 3 in the Tentative Agenda Decision as it is common for loan agreements to include conditions that vary over time to cater for a company's specific circumstances. For example, considering seasonality of the business or different stages of a business life cycle, such as increasing liquidity ratio conditions as a company grows. Applying the Committee's conclusions, the classification of these kinds of loan agreements may change from one interim reporting date to another without the entity actually breaching the loan conditions. Moreover, the MASB does not think the lender's intention is that the entity must meet all of next year's covenants before the end of the current year and also notes there could also be clauses in the loan agreement which allow an entity to address temporary covenant breaches, such as application for a waiver.

We also note that, applying the conclusion in the Tentative Agenda Decision, in order for Case 3 to obtain current classification, the entity must ask the lender for a waiver of the 30 June 20X2 covenant before 31 December 20X1, even though the entity complies with the working capital ratio at 31 December 20X1 and expects to comply with future covenants. We do not think any bank would agree to waive a covenant six months in advance and such a request would damage the entity's relationship with its lender unnecessarily.

The MASB is also concerned that the Tentative Agenda Decision may have other unintended consequences. For example, it only addresses one type of covenant, namely a particular working capital ratio at a given date. However, there are many other covenants in bonds and other debt agreements, including those regarding future profits, cash flows and non-financial covenants, for example relating to an entity's activities. The MASB questions whether, applying paragraph 69(d), an entity is required to assess compliance of all covenants set for the following twelve months based on conditions at the reporting date and is concerned about the practicalities of this.

Unless IAS 1's rationale for delinking the financial reporting from compliance with loan covenants is clear and logical, many entities, lenders and other financial statement users will find the classification outcome confusing and counterintuitive, and entities will find it difficult to rationalise this outcome in their liquidity risk reporting. We also observe that if more loans are classified as current this may result in additional breaches of covenants based on liquidity ratios.

[1] Paragraph 19 of IAS 37.

If you need further clarification, please contact the undersigned by email at beeleng@masb.org.my or at +603 2273 3100.

Thank you.

Yours sincerely,

TAN BEE LENG
Executive Director

February 15, 2021

Ms Sue Lloyd,
Chair, IFRS Interpretations Committee,
Columbus Building
7 Westferry Circus
Canary Wharf, London E14 4HD
United Kingdom

Dear Ms. Sue,

Subject: Comments of the Institute of Chartered Accountants of India (the ICAI) on Tentative Agenda Decision (TAD) issued by IFRS Interpretations Committee on 'Classification of Debt with Covenants as Current or Non-current (IAS 1)'

The Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) welcomes the opportunity to comment on above referred Tentative Agenda Decision of IFRS Interpretations Committee.

The aforesaid Tentative Agenda Decision dealt with the application of requirements of paragraph 69(d) and explanation paragraph 72A of IAS 1, *Presentation of Financial Statements*, to determine whether the entity has right to defer the settlement of a liability for at least twelve months after the reporting period when (a) the right to defer settlement is subject to the entity complying with specified conditions; and (b) compliance with the specified conditions is tested at a date after the end of the reporting period. These provisions were amended/added by the IASB in January 2020.

As a part of the amendment, paragraph 72A was added to clarify that if right to defer is subject to conditions, entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date. It has been noted that paragraph 72A was not included in the Exposure Draft of amendments to IAS 1 issued by IASB in 2015 and, therefore, was not exposed for public comments. We also noted that there is no clarification in the Basis for conclusions (BC) for including this paragraph in IAS 1.

Apart from the above observation, we have following concerns on TAD clarifying application of amendments to IAS 1:

In the aforesaid TAD, the IFRS Interpretation Committee explained the provisions of paragraph 72A taking 3 particular fact patterns. In all the three cases explained in the TAD, it was concluded that the liability shall be classified as current at the reporting date. However, our concern is with regard to Cases 2 and 3 of the TAD, where the conditions are to be tested on a future date as specifically mentioned in the terms of the loan agreement but the same are tested on the reporting date, i.e., prior to the actual testing date, to determine the classification of the loan liability.

In Case 2, the specified conditions need to be met at the contractually agreed testing date (31 March 20X2) and the entity expects that the conditions will be met at that date. In Case 3, the entity is meeting the specified condition at the reporting date (31 December 20X1) and the entity expects to meet the condition at the future period (30 June 20X2). In both the cases, as per the terms of the agreement, the entity is not under obligation to fulfil the conditions at the reporting date and, accordingly, there is no actual breach of specified conditions at reporting date. Further, the entity expects to comply with the specified condition at the testing date and therefore, there may not be a breach of the condition at the testing date. Accordingly, the classifying of such loan liability in anticipation that the specified conditions will not be met in future is not appropriate and may appear counter-intuitive as the specified condition is not breached at the reporting date.

In our view, case 3 is unnecessarily stretched wherein, condition to be tested on the reporting date is met but still the liability is classified as current due to hypothetical condition testing. In our view if all the times the higher/stringent condition is to be met then prescribing different conditions/ratios for different dates has no meaning. Sometimes testing of conditions at a future date is due to certain reasons, such as, seasonal nature of business, new businesses in gestation period, etc. Accordingly, testing future covenants as on reporting date that entity is expecting to meet in future, is unduly harsh and may adversely impact the financial ratios of the entities.

It has been felt that this does not faithfully represent the economic reality. Where the loan agreement does not require a particular condition to be met at the reporting date but testing the same on the date on which the entity is not expected to meet those conditions and classifying the same as current in anticipation does not fairly represent the economic reality. Had that been the case, the loan agreement should mention that a particular condition should be met at all the times without mentioning any specific date.

In accordance with paragraph 75 of IAS 1, the entity may classify a liability as non-current if the lender agrees to provide a period of grace ending at least twelve month after the reporting period. In practice many a times breaches are condoned by the lender but case 2 and 3 will have practical difficulty wherein the entity will be required to obtain a waiver of covenant before actual breach. For example, in case 3, the condition to be met by 30 June 20X2 will have to be condoned before the end of 31 December 20X1, even though the entity complies with the working capital ratio required to be met on 31 December 20X1 and the entity expects to comply with future covenants. In our view, in practical situation the lender will not consider the waiver of breach of specified condition at the end of the reporting period (30 December 20X1) which is required to be met at future testing date (30 June 20X2). Hence, the liability will get classified as current.

We believe that TAD requires to perform a hypothetical test at the reporting date even though the criteria is required to be met at a later date, i.e., after the reporting period. This may require classification of long-term agreements as current which does not represent the true position of the business operations. Also, actual contractual rights and obligations are disregarded by such mechanism and, therefore, may require to consider reclassifications of a liability between current and non-current regularly without even breaching the covenant conditions.

We also noted that TAD explained the provision of paragraph 72A by taking only one type of covenant, i.e., fulfilling specified working capital ratio. However, there may be many other covenants including procedural conditions which are not substantial, such as, submission of environment clearance certificate at the balance sheet date for setting up a factory, because the matter is pending before the Environment Ministry since the Environment Ministry usually takes a long time in clearing various proposals, submission of insurance details where entity has taken the insurance but not submitted to lender, etc. Accordingly, further clarity is required on whether an entity is required to assess compliance of such procedural conditions as well.

On the basis of the above, we are of the view that a liability should be classified as current only when the entity expects at the reporting date that the condition would not be met at a contractually agreed testing date and the entity does not have a right to defer settlement of a liability for at least twelve months after the reporting period.

Therefore, we request the IFRS Interpretation Committee to refer the matter to IASB to reconsider the amendments to IAS 1. We particularly recommend the IASB to consider deleting the last sentence of paragraph 72A.

With kind regards,

Chairman
Accounting Standards Board
Institute of Chartered Accountants of India

PO Box 1411
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15 February 2021

Ms Sue Lloyd
Chair IFRS Interpretations Committee
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Online submission: IFRS - Classification of Debt with Covenants as Current or Non-current (IAS 1)

Dear Sue

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

I am pleased to make this submission on the above Tentative Agenda Decision (TAD) relating to Classification of Debt with Covenants as Current or Non-current (IAS 1).

I have extensive experience in accounting advice on International Financial Reporting Standards across a wide range of clients, industries and issues in the for-profit, not-for-profit, private and public sectors.

My clients have included listed companies, unlisted and private companies, charitable and not-for-profit organisations, federal, state and local government departments and agencies in the public sector, and government owned corporations (government business enterprises). I also have some commercial, standard setting and academic experience.

Overall

I do not agree with the TAD conclusions in relation to Case 3. As at 31 December 20X1, the company is not in breach of any of the loan covenant conditions because they are tested at future dates. Consequently, as at 31 December 20X1 the company has the right to defer payment until 31 December 20X6 under paragraphs 69(d) and 72A.

I do not agree with the approach adopted in the TAD which I regard as a surrogate hypothetical test. The exposure draft for the amendments was about determining the rights as at balance date. It does not matter what the surrogate hypothetical test for future covenant testing dates arrives at, i.e. whether the surrogate hypothetical test is met or not met – because the actual covenant test is met the bank cannot call the loan as at 31 December 20X1 and the company has the right to defer payment until 31 December 20X6. Consequently, the loan should be classified as non-current.

The surrogate hypothetical test essentially makes an estimate of events that will occur after balance date (by assuming the balance date situation will continue) which are inconsistent with amendments to IAS 1 that concentrates on rights at balance date.

If the IASB wanted to take into account estimates of future events, it should have made amendments that allow the use reasonable and supportable forward-looking information that is available without undue cost or effort.

It does not make sense to me to exclude reasonable and supportable forward-looking information etc. but to require the use of balance date information that is known to be inappropriate (e.g. due to the cyclical or seasonal nature of the business).

Real-life consequences of the TAD will cause a breach of loan agreements

The application of the TAD reasoning in Case 3 would involve a real-life breach of the loan agreement causing it to be payable on demand – talk about self-fulling prophecies! While the covenant would initially be met (at 1.05 times using unadjusted balance sheet amounts) at 31 December 20X1, applying the TAD reasoning would mean that the loan would be classified as current. This would consequently reduce (presumable significantly) the working capital ratio of the company – most likely causing the ratio (using adjusted amounts) to be (far) less than 1.0, thereby triggering a real-world breach of the lean agreement – when, in reality there has not been a breach of the agreement!

Non-financial covenants

Below are some non-financial covenants, or events of default, from actual loan agreements. Those selected are outside the control of the borrower that could cause the loan to be callable within the next 12 months after balance date.

It is inconsistent that some events that may occur in the next 12 months after balance date, that would cause the loan to be callable, are ignored under the TAD reasoning, but events that have not occurred and can be rectified before they occur (the surrogate hypothetical working capital ratio test) are assessed as having happened, when they have not.

Selection of loan agreement clauses

- A material adverse change or event.
- Change of control of the borrower. For example, in the lender's opinion there is a substantial change (direct or indirect) in the company or its management, ownership, or control.
- The borrower changes its constitution without the lender's prior consent (this is in the control of the shareholders, not the directors).
- Borrower enters into any amalgamation, consolidation, demerger, merger or corporate reconstruction without the lender's prior written consent.
- If listed, shares are suspended for 10 business days or more.
- Money is used for an … improper purpose or to finance … improper … activity.
- Any expropriation, attachment or sequestration affects any asset or assets of the borrower. For example, any court, government, or government agency, justice of the peace, police officer or other official does anything relating to any property (for

example, issuing a notice, making an order, resuming, seizing, freezing, restraining dealing with, confiscating or forfeiting any property, or revoking any authorisation).

- It becomes unlawful for the borrower to perform any of its obligations under any facility document.
- You or anyone else associated with the loan is a Proscribed Person (linked to money laundering).
- The lender estimates that the development project costs still payable exceeds the available amount under the facility by 5%.
- The lender believes that the development project will not meet the planned deadline.

Interim financial reports – annual covenant tests – seasonality

The TAD reasoning will also cause problems in interim financial reports where covenants are tested annually, and the company is subject to cyclical or seasonal variations in their results – which is many companies that are affected by Christmas and other major event sales, and summer holiday shutdowns. The financial statements will need to be prepared (for example 6 months ended 30 June) when the covenant would be tested under the loan agreement at 31 December. Applying the TAD reasoning would mean that the covenants that would be tested as at 31 December would need to be calculated at 30 June, which may result in the loan being inappropriately classified as current.

Then, because of the seasonality, the covenant is met at 31 December, so the loan is classified as non-current. Then six months later, the process repeats, and the loan is classified as current.

This seems to be a ridiculous outcome – if the bank wanted to test the covenant every six months, they could have included such a requirement in the loan agreement. In this example, they did not, so the accounting standards should not make up some sort of hypothetical test that results in inappropriate classifications.

Taking the above example further, if the loan agreement had different covenants for 30 June and 31 December, designed to take into account seasonality, the loan may well have to be classified as current because of the hypothetical test for 31 December is breached, when the actual covenant for 30 June was met at balance date – similar to Case 3.

Changes to loan agreements

I do not agree with companies having to change their loan arrangements because of the accounting change (should the TAD reasoning prevail), particularly when the requirements of the loan agreements are clear as to when covenants are tested. And what would the amendment to the loan agreement be for Case 3? Something along the lines of “we agree that the covenant will not be tested at a 1.1 threshold at 31 December, but will be tested at the 1.1 threshold on 31 March”? Well, that is what the loan already says!

Due process

The conclusions in the TAD are contrary to many people’s expectations of the changes proposed by the IASB – which were aimed at being minor changes, concentrating on rights at balance date, and not taking into account expectations of events after balance date. The surrogate hypothetical approach is not something that was exposed by the Board in the

Exposure Draft and it has not been exposed for comment and identification of unintended consequences. If the conclusions by the IFRS Interpretations Committee are correct (which I disagree with), the changes made by the Board should have been re-exposed as they were not exposed and are a fundamental change to current practice of determining rights as at balance date.

Intention of the IAS 1 amendments

My experience with current practice is that the approach is to determine whether the loan agreement (and covenants based on balance date or pre-balance date information) has been met such that the loan agreement is in compliance – and that the bank as at balance date does not have a right to call the loan within 12 months. There was also sometimes a management expectation override, with the main practical issues that needed resolving were:

(a) Should companies take into account events after balance date, for example the loan was repaid early (i.e. before contractually due) between balance date and when the financial statements are approved.

(b) Should companies take into account management expectations of compliance with future covenants, e.g. when using reasonable and supportable forward-looking information that is available without undue cost or effort, management expects that the future covenant will be breached.

Some preparers also argued that covenants using balance date information, but tested by the bank after they received the audited financial statements, should not be considered as a balance date condition (issue (c)).

I believe that the intention of the amendments was to remove the reference to unconditional (as loans are often subject to conditions, such as not material adverse events) and to look at rights that existed at balance date – did the company comply with the loan agreement at balance date, or conversely, were there any breaches of the loan agreement.

I believe that issue (b) above has not been resolved, as paragraph 69(a) can still be read as requiring any liability (not just working capital) expected to be paid within the next 12 months after balance date to be classified as current (because of the series of 'or' conditions). That is, if 69(a) is met (loan is expected to be repaid, or due and payable within 12 months), then the definition of current is met, irrespective of any rights under 69(d).

There is still an apparent conflict in the standard for issue (a) – based on the reading above for paragraph 69(a) – though it appears newly inserted paragraph 75A is supposed to resolve the issue.

I believe that issue (c) has been clarified by paragraph 72A – but I do not read paragraph 72A as requiring the surrogate hypothetical approach adopted in the TAD.

Yours sincerely,

David Hardidge
https://www.linkedin.com/in/davidhardidge/

Extracts from IAS 1 amendments:

69 An entity shall classify a liability as current when:

- **(a) it expects to settle the liability in its normal operating cycle;**
- **(b) it holds the liability primarily for the purpose of trading;**
- **(c) the liability is due to be settled within twelve months after the reporting period; or**
- **(d) it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.**

An entity shall classify all other liabilities as non-current.

72A An entity’s right to defer settlement of a liability for at least twelve months after the reporting period must have substance and, as illustrated in paragraphs 73–75, must exist at the end of the reporting period. If the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date.

Email: billymanbas@gmail.com

International Financial Reporting Interpretations Committee (IFRIC)
Columbus Building
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London
E14 4HD
By email to: commentletters@ifrs.org

12 February 2021

Dear Ms Lloyd

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

Thank you for the opportunity to provide responses to the proposed TAD.

Given the amendments to IAS 1 on the classification of current/non-current liabilities and effective from 1 January 2023, specifically paragraph 72 A, it ***may*** appear that the proposed TAD arising from the fact pattern and in all three cases (1-3), is appropriate. However, in my view, the conclusion reached can only be confirmed through a very narrow and specific interpretation of paragraph 72 A. Specifically, Paragraph 72 A states that: *"The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date"*

It is not clear from the IAS 1 amendments and related limited guidance, what is meant or implied by *"…even if the lender does not test compliance until a later date".* The IAS 1 amendment can be interpreted to mean that compliance is tested at a later date but with the actual conditions and data at the reporting date i.e say 3 months after the end of the reporting when audited financial statements are available but at the reporting date of the financial statements. Under this interpretation, it is clear that a covenant breach of a debt instrument at the end of the reporting period (say 31 December) but which is tested by the lender when the audited financial statements are issued (say 31 March) based on the financial position (or performance for the period to) 31 December, would result in the said instrument being classified as current under case 1 and potentially non-current under case 2 and 3.

In reaching its TAD for cases 2 and 3, the IFRIC appears to have interpreted *"…even if the lender does not test compliance until a later date"* quite narrowly from the fact pattern provided, to include all subsequent required tests on information, data, facts and circumstances that are not currently available and to base future test results on a single test at the reporting period (whether breached or not). It is unclear whether the IASB intended this outcome as given your interpretation, an entity may always be required to reflect a liability as current in its reported financials statements but actually never have to repay early, or have demanded by the instrument holder early repayment. This would clearly mispresent information to users of financial statements.

I do however agree with the result of case 1, as in that circumstance the condition is tested at the reporting period (even if the lender will only formally test it on the release of the audited financial statements, say in March) and found to be in breach.

However, in the second and third cases, with a continuous reporting requirement, the entity is not in breach with the debt covenant at the reporting date, and that based on that test, it has the right to defer settlement for a twelve-month period, while the lender has an obligation not to demand immediate payment. Legally, the lender cannot demand early payment as there is no condition that has been breached. The substance of the matter is in this case consistent with the legal outcome at the reporting date. That circumstances may change between the reporting date and the next testing date, can be beyond the control of the entity, and should perhaps not be taken into account as set out by the amendments to IAS 1 given that management expectations should not be considered.

The TAD reached in cases 2 and 3 confirm the potential unintended consequences of the lack of due process undertaken by the IASB in proceeding with the amendments and lack of clear and concise drafting of their intention. Cases 2 and 3 demonstrate how less useful and meaningful information the statements of financial position would be as reality could confirm that the entity passes its tests and never repays its debt early (through seasonality or cyclicality), but throughout the instrument period continues to reflect the debt as current due to the TAD or even potentially a situation where the classification keeps changing at each public reporting period of the entity.

In Cases 2 and 3, assuming that at the next reporting period (30 June) the condition is passed, in line with the TAD and the debt is confirmed as non-current, is there an implied confirmation of a prior period error in the financial statements at the previous reporting date? As the amendments of IAS 1 do not now allow use of management expectations (estimates and judgements), the change in the classification of the debt instrument to non-current, cannot be viewed as a change in estimate and thus potentially only as a prior period error. Would the entity be required to restate its financial statements given that it had passed the covenant test at the test date but due to an accounting requirement was viewed as a failure with the resultant incorrect accounting treatment? Similarly, how would the entity consider its financial statements at its next reportable reporting period, say 30 June, when the test at 31 December, under the amendments of IAS 1, indicate that it had passed the test (using information only at 31 December), but then fails the test at 30 June? Could this outcome also be potentially considered as a prior period error, given the current definition of a prior period error within IAS 8?

The situations provided in cases 2 and 3 could indicate the existence of a prior period error as the amendments in IAS 1 now seem to prohibit the use of reliable information that could reasonably be expected to be obtained and taken into account in preparing the financial statements. Did the IFRIC consider the impact of continuous reclassification of these liabilities in subsequent reporting periods when the TAD interpretation is applied in cases 2 and 3?

The nature of the classification of such instruments which depend on some sort of test, should be ultimately driven by the requirements, including those implied, by the instrument agreement and not by an academic discussion. The fact pattern in case 1 is clear that at the reporting date and the test date (31 December), the covenant was in breach and the debt instrument would be classified as current, under both the previous IAS 1 requirements and the new amendments. The situation in case 3 clearly indicates that the covenant was not in breach at that reporting and testing date. In case 2, there was no testing requirement at the reporting date and legally (as in case 3) the instrument holder is unable to demand early repayment. The new amendments appear, based on the IFRIC interpretation, to suggest that in such situations, the impact of seasonality or cyclicality or even circumstances and effects of the Covid-19 pandemic, are to be ignored and not even considered. This restriction is counterintuitive and may lead entities down a path of continual going concern assessments due to an accounting interpretation that lacks commercial sense and substance. Such continuous assessments would then require the use of judgements and estimates to confirm the applicability of going concern including that the covenant breaches would not arise based on those same management expectations, which under the new amendments to IAS 1, can now no longer be used to determine the reasonable classification of a liability. This appears to confirm an inconsistency within the IFRS literature and requires that the amendments to IAS 1 should be further considered and redeliberated. Additionally, classification of debt as current due to an accounting covenant test breach may have other economic and commercial consequences on an entity, including impacts on its credit rating or customer or supplier relationships which may trigger termination or early settlement terms or other similar clauses within such contracts. This could then trigger or extend going concern issues brought about by the accounting covenant test or even provide indicators of impairment of non-current assets. The broader implications of the new amendments and the proposed TAD could be numerous and create more confusion rather than provide clarity.

This inconsistency suggests that as part of its due process in proposing its amendments, the IASB may not have properly reached out to providers of debt to truly understand the nature and impacts of covenants and how these are used or tested. Consider for example in case 2 or 3 where an entity classifies its liabilities as current due to an "accounting breach" only to then privately confirm to its lenders that this is not the case as (a) it was not required to test at that date or (b) it did not breach the test but accounting literature does not see it that way. Investors would also find this confusing and would not be able to make sense of the financial statements. Additionally, a lender could consider that such classification, despite no official test (case 2) or as in the situation depicted by case 3, the entity to be in imminent breach, which would then have an adverse impact on its own accounting under IFRS 9 (expected credit losses, increasing default risk event), when no such breach is considered imminent due to the seasonality or cyclicality of the entity. Additionally, would the lender now be allowed to classify the entire receivable as current, to be consistent with the same disclosure of its debtor?

I would recommend that entities should be required to disclose the frequency of their covenant compliance requirements and state the outcome of such testing where the reporting date and test date are aligned. Where the test date is subsequent to the reporting date, that fact should be disclosed and linked into the entity's broader disclosure around going concern, should this be affected, debt and liquidity management and how it intends to overcome or resolve such breach, should the breach occur at the next testing period. This type of information would be more meaningful and provide better reliable information to users compared to a situation in either case 2 or 3 where liabilities could be perpetually disclosed as current but never repaid early as there is never a breach on the test dates or where classification changes at each reporting period.

I strongly urge the IFRIC to consider the broader commercial and economic consequences and the legal impacts of classifying a liability as current when no such legal requirement arises, before it proceeds further and rather request the IASB to reconsider the amendments given the issues raised by the comment letters. I would also request the IFRIC publish its deliberations and responses to comment letters, irrespective of its decision in the interest of transparency and clarity.

Thank you again for the opportunity to provide comments and please do not hesitate to contact should you require any further information.

Your sincerely,

V Petrolekas

IFRS Interpretation Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Stockholm 15th February 2021

Tentative Agenda Decision, Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements)

FAR, the Institute for the Accountancy Profession in Sweden, is responding to your invitation to comment on the above Agenda Paper.

FAR agrees that the conclusions to the three illustrative cases in the Tentative Agenda Decision reflect the new IAS 1 requirements introduced by the amendments to IAS 1 Presentation of Financial Statements: Classification of Liabilities as Current or Non-current and Classification of Liabilities as Current or Non-current. However FAR has significant concerns with the outcomes.

FAR notes that in neither of the three cases there are an actual breach of the condition by the end of the reporting period. In all three cases the entity expects the condition to be met at the testing dates in the subsequent year, FAR believes that this is the most crucial condition to assess if the debt is current or non-current, as an example; if the entity´s business is highly seasonal and by the end of the reporting period the working capital ratio is normally low but normally high at the testing date six months later, it would not be fair to classify the debt as non-current. FAR is therefore concerned about the amendments to IAS 1 leading to the outcomes in the three cases, therefore FAR recommends IFRS Interpretation Committee not to finalize the Agenda Decision but instead refer the issue to the IASB for further consideration regarding the amendment to IAS 1.

Yours sincerely,

Pernilla Lundqvist
Chairman Accounting Practices Committee

COMITÊ DE PRONUNCIAMENTOS CONTÁBEIS

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February 15, 2021

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

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1]welcomes the opportunity to respond to the Tentative agenda decision Classification of Debt with Covenants as Current or Non-current (IAS 1 Presentation of Financial Statements).

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Rogerio Mota

Rogerio Lopes Mota
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)

[1]The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

We appreciate the Committee's efforts to clarify the International Accounting Standards Board's (the Board) amendments to IAS 1, as by accompanying the Tentative Agenda Decision from the Committee, we realized that the application of IAS 1.72A, as written, will achieve a different accounting outcome than we would expect.

We agree that the conclusions set out in all three illustrative cases reflect a literal reading of the new IAS 1 requirements; however, **we have significant concerns with the potential outcome of these amendments in Brazil**. **We do not agree** with: (i) the potential mismatch between the accounting classification and the loan's contractual terms and conditions; and, (ii) with the narrow focus of financial position covenants (i.e., without a clarification on how to apply the concept added in IAS 1.71A on performance and qualitative covenants). (iii) We also would like to, even though it is not the object of outreach, highlight our long-standing disagreement with IAS 1.74. Please, see below the summary of our comments on the Tentative Agenda Decision issued by the Committee.

(i) Potential mismatch between the accounting classification and the loan's contractual terms and conditions.

The amendments introduce a new simple test, which could be considered easy to apply as no estimation is required. But, the outcome of applying this amendment, as illustrated in all scenarios analysed by the Committee, does not represent a relevant information to users of financial statements. We believe that 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.

The test introduced by the amendments ignore both contractual terms and conditions in our jurisdiction and how covenants are designed to attend certain specificity of the entities (e.g., start-ups). 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. We do not agree with this outcome – as we do not believe the approach introduced by the Board results in an outcome that provides relevant information to users of the financial statements.

(ii) Focus of the TAD is too narrow

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) and is limited to the three fact patterns described. The TAD does not clarify if/how classification of a loan with a financial performance condition (e.g. annual revenue / earnings target to be tested after the reporting date) or qualitative covenants (e.g. submission of audited financial statements of the borrower by a certain date) 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 resolve the ambiguity in 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 with covenants. 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. Thiscould lead todifferentinterpretationsarising in practice.

(iii) Applicabilityof IAS 1.74

Despite the rationale described above, we take the opportunity to address a different issue already expressed by CPC in the response to the Exposure Draft 2015/1 – Classification of liabilities. We believe that if a debt arrangement is renegotiated after year-end (e.g. a waiver was obtained for a covenant default), but before the release date of the financial statements, should be classified as non-current liability at year end in order to provide meaningful information to the users of the financial statements. In many cases, entities realize that they are in default after the preparation of the financial statements, thus after year-end, and immediately request a waiver to the counterparty, obtaining such waiver before the release date of the statements. In paragraph 73 (R) the Board express its view that said waiver is not a company "right" at the end of the report date, and as such, the company should classify the debt breach as a current liability. We kindly request that the Board reassess such issue in this revised standard. We believe that classifying the debt as a current liability, and disclosing the waiver in a subsequent event note may not be fully meaningful for the user of the information in this specific scenario, and in fact, will provide incorrect and misleading information to such user.

***

As a response of our comment letter, we believe that the Committee should send this matter to the Board; then, we believe that the Board members should review its evaluation to add IAS 1.71A hypothetical test (or improve it) and to review paragraph IAS 1.74, as explained above.

לשכת רואי חשבון בישראל
Institute of Certified Public
Accountants In Israel
نقابة مدققي الحسابات في إسرائيل

1020_11512

February 15, 2021

IFRS Foundation
Columbus Building
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London E14 4HD
United Kingdom

Dear Madam/Sir,

Re: **IFRIC's Tentative Agenda Decision: "Classification of Debt with Covenants as current or non-current (IAS 1)"**

The Institute of Certified Public Accounting in Israel has considered the IFRIC's Tentative Agenda Decision (the **"Tentative AD"**) and the examples with respect to the forthcoming application of the Amendment to IAS 1:"*classification of liabilities as Current or Non-current*", published in January 2020 (the **"IAS 1 Amendment"**).

We welcome and encourage the initiative taken by the IFRIC on this issue, and appreciate the opportunity to comment on the Tentative AD.

If you have any questions related to this letter, please contact head of our professional staff Mr. Din Krispin (din@icpas.org.il).

1. Summary

We believe that IFRIC has interpreted and demonstrated correctly the new requirements included in the IAS 1 Amendment. Nevertheless, we have heavy concerns with regard to the possible outcomes of those requirements (as duly reflected in the Tentative AD examples). In section 2 to this letter, we explain how and why the new requirements in the IAS 1 Amendment (paragraph 72A in particular) have created a fundamental change that was not included within the exposure draft of this amendment.

We believe that this irregular (and probably unprecedented) situation has stemmed from a mistake which led to non-compliance with IASB's due process; in particular, the Board's decision not to re-expose the IAS 1 Amendment for public comments,

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while making changes (especially adding paragraph 72A) that are definitely not of minor scope. We believe that re-exposure would have raised the heavy concerns which are reflected now by the Tentative AD and, with a high degree of probability, the current unfortunate situation would have been avoided. In section 3 below, we elaborate on this issue.

Section 4 concludes this letter with our request that the IFRIC recommend to the Board to suspend the IAS 1 Amendment for further deliberation and public comments.

2. Fundamental changes and far-reaching effects of the IAS 1 Amendment

Israel has a developed market for quoted debentures and a wide-spread use of covenants for loans and debentures; taking into account our experience in dealing with such covenants, lenders and holders of debentures and their effect on financial statements, we have heavy concerns, as explained hereafter, with respect to the forthcoming adoption of IAS 1 Amendment, as reflected in the Tentative AD.

We believe that the final IAS 1 Amendment includes fundamental changes (the addition of paragraph 72A in particular) that are far reaching and have wide consequential effects, as detailed below:

(a) Although the wording of Paragraph 72A of IAS 1 seems at first unequivocal, it raises a logical contradiction. One can "expect" to comply, or "have adequate measures" to comply, with future conditions, but how can one comply today with a future condition?

The very reference to the level of the metric to be tested during the next 12 months expresses an assumption or hypothesis that says: "tested or not, if your metric at the end of the reporting period does not meet any of the metrics you are required to meet within the forthcoming 12 months, you are not going to meet those metrics, and therefore you need to either obtain a 12 months waiver (before the end of the reported period), or classify the liability as current". Leaving paragraph 72A as it is, without any possibility for management to demonstrate that the entity can meet or cure the future metrics, or that this is a seasonality issue, is a result that is not just or reasonable. It is entirely arbitrary. This outcome is not less arbitrary when deducing that the entity has 12 months free run, if the metric at the end of the reporting period is slightly higher than those required during the coming 12-month period.

This can result in liabilities that are classified in and out the current section, from one quarter to another, with no real meaning or justification. Such outcome obviously does not support the understandability of IFRS financial statements.

(b) This outcome also overrides both the legal and economic essence, and the intension of the parties, of any loan agreement. That is, both the lender and the borrower (the entity) have agreed to terms of covenants that are expected to be met in the future, and not to be met as of a date that is 3, 6, 9 or 12 months earlier. In the same manner, a contractual obligation to meet <u>only annual</u> covenants, cannot be applied and "tested" at interim reporting dates.

Quarterly covenants (which are quite common in Israel), often take into account expected future events. That could be the case with respect to adjusting the effects of seasonality, or, for covenants that are based on balance sheet ratios, an impending assured fund raising, etc. It is clear in these situations that the lender does not intend nor expects the entity to meet these covenants as of a date earlier than the date set in the loan agreement for the covenant to be tested.

(c) Another possible effect of implementing the extant IAS 1 Amendment is that the accounting may affect the economics of an entity, rather than reflecting it: i.e., it may create a rolling effect with other liabilities and covenants that can lead an entity to collapse. For example, following the fact pattern in Example 2 in the Tentative AD, an entity classifies a liability as current (despite the fact that no test in required at the reporting date). This, in turn, creates working capital deficiency, that may trigger a default clause of another long-term liability, called for immediate repayment.

A working capital deficiency that does not faithfully represent the actual economics at the end of the reporting period (as potentially created in situations like those in examples 2 and 3 to the Tentative AD) raises a high threshold for an entity that is required to explain why this is not affecting the "going concern" assumption, or why it should be taken out of any financial analysis. It may also trigger undesirable explanations why IFRS financial statements do not produce a true and fair representation of the real economics, as well as additional regulatory requirements.

(d) We find the view expressed by one of the IFRIC members in the discussion around the Tentative AD (in December 2020), that entities should take more care in setting and managing their covenants, to disregard the complexity, volatility and disruption that events have on the economics of an entity's reality today. Many indices/metrics are not predictable and despite the desire for companies to properly and carefully manage their compliance commitments with lenders, they can always default unexpectedly.

Thus, the IAS 1 Amendment, puts entities in the hands of their lenders, as any request for waiver leads to either higher interest, penalty, or more security to be provided to the lenders. In this regard, it should be noted, for quarterly reporting entities, that a 12 month right of deferral would have to be renegotiated with the lenders at the end of every quarter, regardless of whether the lenders test for compliance at the end of that particular quarter, or not. This may be another onerous and costly result of the extant IAS 1 Amendment.

From our experience, negotiations and waivers, in particular when it comes to the holders of publicly issued debentures, or debentures issued to accredited investors, becomes a long and tedious process, sometimes quite impractical. Can you imagine the surprise and absurd discussion one may have with lenders before December 31 in order to accept future waiver for covenants in the coming quarters, <u>when the lender does not test compliance on December 31</u>? (example 2) ("Are you saying that you are NOT going to meet your coming 30 June's covenant?"); which brings us again to the issue of "accounting that affects the economics".

(e) We welcome IFRIC's own initiative on this issue. IFRIC found it necessary to take this initiative "in response to feedback and enquiries from some stakeholders", even though there are still 2 years until the effective date of this amendment and although this is not the way IFRIC usually works. This very fact is an acknowledgment of the wide-spread and heavy concerns about this issue. It is also another evidence that the addition of paragraph 72A to the IAS 1 Amendment was definitely no minor scope change that could be done without re-exposure of the IAS 1 Amendment for public comments (as explained in section 3 below).

3. Non-compliance with IASB's due process

As previously noted, we believe that the Board's decision not to re-expose the IAS 1 Amendment, taken in the September 2019 meeting, is the basis of the current unfortunate situation (as explained in section 2 above). Because of that decision, we, as well as other responders, did not have the opportunity to respond properly to the far-reaching changes made in the IAS 1 Amendment (the addition of paragraph 72A in particular) after the exposure draft.

Taking a retrospective view of the changes that were made after the original exposure draft of the IAS 1 Amendment, the arguments presented by the staff in Agenda Paper 29 for the Board's September 2019 meeting (and followed by the Board) had no merit:

"Item 19 (Effects analysis)

The staff do not think the proposed amendments have major implications for financial reporting. The amendments would clarify IAS 1 requirements but not fundamentally change them. Furthermore, the amendments would affect only the presentation of liabilities in the statement of financial position—not the amount or timing of recognition of any asset, liability income or expenses, or the information that entities disclose about those items."

In contrary to the above citation, the presentation of liabilities as current or non-current may have in fact considerable implications for financial reporting (as elaborated in section 2 above). It also affects many aspects in management of an entity's resources, inter alia – costly and onerous dealing with lenders, responding to regulators' requirements in matters of working capital deficiency. It is also a major issue in the consideration of the entity's ability to meet its obligations and the evaluation of the "going concern" assumption, and more.

"Item 26 (Re-Exposure):

The staff conclude that the final amendments do not require re-exposure because:

(a) the changes have been made in response to requests from respondents to the Exposure Draft and clarify the Exposure Draft proposals without fundamentally changing them;"

As explained in section 2 above, the changes made to the exposure draft constituted in fact a fundamental change (the addition of paragraph 72A in particular). In this regard, it should be noted that we were not able to draw a direct line between the tentative decisions made in the IASB February 2016 meeting, and the final wording added in paragraph 72A.

"(b) the clarifications affect only presentation requirements—not the amount or timing of recognition of any asset, liability, income or expenses;"

Needless to say, these were not just clarifications, they presented a new concept that requires to "test" covenants in advance of their actual testing date. The classification of a long-term liability as one that can be presented for immediate repayment by its lender is a major issue. It affects the very basics of presentation of financial statement, which is the "going concern" assumption. This may even be considered a higher threshold than "timing of recognition …", etc.

Besides, item 6.28 of the Due Process Handbook determines as follows:

"The Board should give more weight to changes in recognition and measurement than disclosure when considering whether re-exposure is necessary."

Clearly, according to item 6.28, a lesser weight may be attributed to changes in disclosure requirements - not to changes in presentation requirements.

"(c) the most significant of the clarifications applies only to liabilities with equity settlement features. As explained in paragraph 16, the Board consulted members of the IFRS Interpretations Committee on the practical consequences of this clarification. Committee members from large accounting firms were able to consult colleagues with practical experience of classifying liabilities with equity-settlement features. Given the quality of information fed back to the Board from that targeted consultation, the staff do not think the Board is likely to learn much more by re-exposing the proposals for general public comment."

This goes to prove that, while the attention was drawn to this clarification, the magnitude of the change imbedded in the addition of paragraph 72A was missed.

A closer reading of items 6.25 - 6.29 of the Due Process Handbook (Re-exposure criteria) shows that the staff recommendation and arguments, as cited above, did not consider various criteria, such as the requirement in item 6.26:

"The Board needs to consider whether the revised proposals include any fundamental changes on which respondents have not had the opportunity to comment because they were not contemplated or discussed in the Basis for Conclusions accompanying the Exposure Draft. … If the Board is satisfied that the revised proposals respond to the feedback received and that it is unlikely that re-exposure will reveal any new concerns, it should proceed to finalise the proposed requirements."

To conclude this section, we would also mention that the project of the IAS 1 Amendment was discontinued for several years after the exposure draft was published in 2015. Clearly, restoring a process after several years of discontinuation is always challenging because of staff changes and other various aspects. This fact by itself is another consideration why the re-exposure of the IAS 1 Amendment should have been considered much more carefully.

4. Conclusion and recommendation

The Tentative AD demonstrated and highlighted the fact that the outcome of the changes made in the final IAS 1 Amendment is much more dramatic and far reaching than intended, or publicly understood; it also surfaced the fact that the IASB due process requirements regarding re-exposure were not fulfilled in this case.

Hence, in these exceptional circumstances, we urge IFRIC to recommend to the Board to suspend the IAS 1 Amendment for further deliberation and public comments (while postponig, in the meantime, early adoption).

Sincerely,

Arnon Ratzkovsky, CPA (Isr.)
Chair of the Professional Council

Yael Gerassi, CPA (Isr.)
Chair of Financial Reporting Standards Committee

ASSOCIATION OF NATIONAL ACCOUNTANTS OF NIGERIA

Comments on the Tentative Agenda Decision and comment letters on Classification of Debt with Covenants as Current or Non-current (IAS 1).

The Association of National Accountants of Nigeria (ANAN) has critically and painstakingly reviewed the basis of IFRS Interpretations Committee's decision and welcomes the opportunity to comment on the Tentative Agenda Decision and comment letters: Classification of Debt with Covenants as Current or Non-current (IAS 1).

We substantially agree with the tentative agenda decisions and conclusion of the IFRS Interpretations Committee. We are sufficiently convinced that the Committee's illustrations provide adequate demonstration of the application of the recently amended IAS 1. However, we would like to express the following concerns.

First, the classification of debt with covenants as current assets by an entity when it fails to satisfy the criteria specified in paragraphs 69(d) and 72(A) could constitute a significant problem to entities with long-term debts of a large magnitude because of its adverse effect on the entity's liquidity ratios. A probable solution would be a requirement for appropriate disclosure to explain the fact that the high liquidity ratios are as a result of the classification of the debt in accordance with IAS 1.

Second, although the circumstances described in the 3 cases are appropriate, they seem to provide an over-simplistic abstraction of real life situation. In real life, covenants may contain exclusion clause that provides a leeway for the entity in the event of failure to meet stated conditions. For instance, the covenant in the 3 cases may provide that the loan becomes payable on demand if the ratios are not met "except where some mitigating factors are put in place to guarantee the fulfilment of the conditions".

The Association is equally concerned about an entity that may be desperate in meeting particular target ratio(s) for which reason may be compelled to adopt creative accounting practices.

Finally, we believe that the recently amended IAS 1 (Classification of liabilities with covenants as current or non-current) applies to a wide category of liabilities covering a wide range of standards (such as IAS 12, IAS 37, IFRS 2 IFRS 9 and IFRS 16). However, the provisions of the standard apply mostly to liabilities that meet the definition of financial instruments. This fact needs to be emphasized in the amended standard to guide preparers and users of financial statements/reports.

For any further information or clarification, please contact the undersigned.

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INVESTOR IN PEOPLE

International Financial Reporting Standards Interpretations Committee
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11 February 2021

Dear IFRS Interpretations Committee members,

Invitation to comment – Tentative Agenda Decision: *Classification of Debt with Covenants as Current or Non-current* (IAS 1 *Presentation of Financial Statements)* (IFRIC Update December 2020 - Agenda Paper 2)

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above Tentative Agenda Decision (TAD) discussed by the IFRS Interpretations Committee (the IFRS IC) in December 2020.

Overall, we support the IFRS IC's initiative to address the concerns of constituents regarding the amendments of IAS 1 *Presentation of Financial Statements* issued in January 2020. We support the IFRS IC's efforts to provide helpful guidance to facilitate consistency in application of the amendments. However, we wish to share some concerns about specific issues raised in the TAD and highlight certain aspects that we believe require clarification.

Covenants applicable currently vs covenants applicable after the end of the reporting period

The TAD concludes, in Case 3, that the entity does not comply with the conditions applicable at the end of the reporting date, because within the next twelve months a higher threshold (than the one applicable as of the end of the reporting date) applies. In other words, a current position is compared against a future requirement, as opposed to either a current position being compared with a current requirement or a future position with a future requirement. The effect of this is that an entity is required to 'assume' that the future requirement applies currently, or, alternatively, that the current position will remain unchanged at the future date.

The conclusion of the TAD in Case 3 is explained by reference to the requirement in the last sentence of paragraph 72A of IAS 1, i.e., '*The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date*'. However, in Case 3, the covenant is to be tested as of the end of the reporting period, and as such, some believe that the last sentence of paragraph 72A is not applicable. The entity is required to and does test the covenant at the reporting date and meets the conditions. On that basis "*(…) the right to defer settlement (…) exists at the end of the reporting period*" since "*the entity complies with those conditions at the end of the reporting period*".

Case 2 in the TAD is similar in that a current condition is compared with a future requirement, although in that scenario the last sentence in paragraph 72A of IAS 1 may be applicable.

Therefore, to allow consistent application of paragraph 72A in other scenarios as well, we believe that the IFRS IC, in its agenda decision, should clarify the interaction between the conclusion in Case 2 and Case 3 and the wording of the relevant requirement in paragraph 72A of IAS 1.

Inconsistency between paragraphs 72A of IAS 1 and BC48E

In some cases, adjustments may be necessary if the measures are expected to differ significantly from one period to the other in order for the comparison of the current conditions with the thresholds to be meaningful (e.g., considering an annual revenue threshold as at the end of the first quarter). Paragraph 48E in the Basis for Conclusion (BC) in IAS 1 acknowledges that adjustments may be made in certain situations to allow for the comparison of actual performance with a performance threshold applicable to a longer period. In concluding that no adjustments should be made in Case 3, the IFRS IC considered that paragraph BC48E is to be read to only refer to performance-based conditions. We believe that there may be reasons why thresholds are being agreed to be tested only at the end of a specific reporting period (as in Case 2 in the TAD) or why they differ from period to period (as in Case 3 in the TAD). For instance, for entities with seasonal business, specific testing dates and/or varying thresholds may be agreed, and for start-up entities, a period 6-12 months of non-testing may be agreed. In its Agenda Paper AP02 (December 2020 IFRS IC meeting), the staff mentions that BC48E is only relevant to covenants relating to an entity's cumulative financial performance. That is, an adjustment would not be possible in the case of a covenant relating to financial position (which is often the result of future financial performance) or to a non-financial condition, such as covenants requiring audited financial statements by a specific date or covenants becoming effective on change of control. It is not clear why these other conditions are approached differently as the conceptual difference, and also the practical difference, among them - and specifically between performance-based and financial position-based covenants - is not straightforward.

In our view, paragraph BC48E further confuses how to interpret the requirement in paragraph 72A. We are not convinced that making an adjustment as suggested in paragraph BC48E is consistent with the requirement of paragraph 72A.

If the IFRS IC believes that there is consistency between the two, we suggest that it should consider clarifying, in its agenda decision, whether paragraph BC48E is to be read as restricting adjustments in applicable cases only to performance-based covenants, or if similar adjustments may also be consistent with paragraph 72A of IAS 1 in case of other types of covenants such as financial position-based covenants and non-financial covenants.

Furthermore, we are concerned that non-authoritative guidance, i.e., the Basis for Conclusions of a standard, indirectly plays a key role in determining the appropriate accounting.

Removing paragraph BC48E, in reference to it being inconsistent with paragraph 72A of IAS 1, as explained above, will, in our view, result in accounting that, in many cases, will be counterintuitive, and even misleading in some cases. However, keeping paragraph BC48E raises questions along the lines we discussed above, and will, in our view, require additional guidance, including guidance on other than performance-based covenants. Therefore, we believe clarification of the 'rights' concept, and specifically, the requirement in paragraph 72A of IAS 1 may be the best way forward. In that case, for the reasons explained above, the IFRS IC should consider whether recommending to the IASB to revisit the not yet effective amendments may be a better resolution than to finalise the agenda decision.

We also note that a similar issue is addressed in paragraphs 52 and 53 of IAS 33 *Earnings per Share* for dealing with contingently issuable shares. Therefore, in addressing the impact of covenants to be tested at a later date, the Board and the IFRS IC should consider whether IAS 33 provides guidance that could be helpful in developing a consistent approach under IAS 1.

Clarification of the scope of the TAD

Although the TAD refers to the application of the amended version of IAS 1 (effective for annual periods beginning on or after 1 January 2023) in the introductory paragraph, we believe it would be helpful if the second sentence of the second paragraph of the TAD was explicit on the fact that the TAD addresses the amended version only, instead of the current effective standard. More specifically, in the second sentence of this paragraph, we would suggest adding '(as amended)', or similar, when referring to paragraph 69(d) of IAS 1.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully

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15 February 2021

Dear Sue

Tentative agenda decision - IAS 1 - Classification of Debt with Covenants as Current or Non-current

We are pleased to comment on the above tentative agenda decision.

We agree with the IFRS Interpretation Committee's decision not to add this issue to its agenda, and with the reasons set out in the tentative agenda decision. We believe the analysis included in the tentative agenda decision is the appropriate application of the amended requirements of IAS 1 to the three fact patterns presented.

It is clear that IAS 1.72A requires an entity to consider all conditions that must be satisfied in the next 12 months in order for the entity to have the right to defer settlement over that period of time. As illustrated in case 3 of the tentative agenda decision, this would require an entity to assess compliance with all covenants that may provide the lender with the right to demand repayment in the next 12 months as at period end, despite the fact that some of those covenants will only be contractually tested at a later date (e.g. a future quarter end).

However, we have concerns about the results of the application of this requirement to several common fact patterns, which results in counterintuitive results which we consider do not provide useful information to users of financial statements. We believe that it would be appropriate for the Board to reconsider and modify the amendments.

We acknowledge that the amendments were designed to introduce requirements that are easily understood and straightforward to apply. We have therefore considered whether, if the Board did add the issue to its agenda, the requirements could be amended in a way that did not introduce significant complexity while at the same time addressing the issues that we note below. We believe that this objective could be achieved by requiring compliance with covenants, that will need to tested in future periods, to be assessed with reference to forecasts and projections for future financial performance and positions.

We note that this approach would be consistent with that used when assessing whether an entity is a going concern. This is because the assessment of going concern is carried out using expected cash flows which take into account whether, at a future date or dates, a lender is expected to be capable of demanding repayment of amounts advanced to a borrower.

In many jurisdictions, balance sheet covenants are tested at several points throughout a year (e.g. quarterly), with those covenants being adjusted to take into account the lender's expectation that the borrower's financial position will differ over that period.

For example, a wide variety of entities have 'high' and 'low' points in their typical operations when balance sheet ratios fluctuate significantly. This is very common in the retail sector, where many entities earn a significant amount of their profits in a single quarter (e.g. the traditional holiday season occurring in November-December). This type of seasonality requires businesses to incur significant marketing and promotional expenses, as well as purchase significant inventories in Q2 and Q3 in preparation for the 'high' season in Q4. These expenditures result in current ratios and debt to equity ratios fluctuating significantly. In our experience, lenders are aware of this and adjust their quarterly (or monthly) covenants accordingly such that entities remain contractually compliant with covenants during these periods as long as they operate within expectations established at the time the covenants were determined.

If case 3 from the tentative agenda decision were applied to this common fact pattern, a common outcome would be as follows, using an illustrative working capital ratio for a retailer where Q4 is the busiest period in terms of sales:

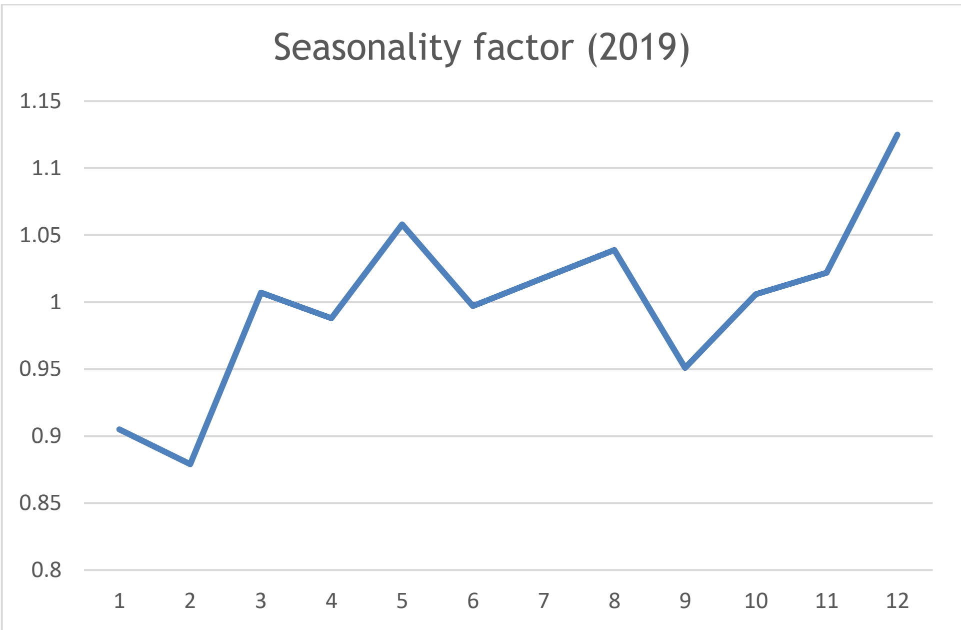
Period tested	***Contractual working capital covenant ratio***	***Working capital covenant to be tested based on IAS 1.72A and tentative agenda decision****	***Actual working capital ratio calculation as at each period end***	***Resulting classification of bank loan applying IAS 1.72A***
2023 Q3	1.00	1.20	1.01	Current
2023 Q4	1.20	1.20	1.22	Non-current
2024 Q1	1.10	1.15	1.13	Current
2024 Q2	1.15	1.15	1.16	Non-current

*The ratio used to assess compliance with IAS 1.72A is the highest future ratio in the next 12 months, as the entity must comply with this higher ratio within the next 12 months in order to have the right to defer payment for the next 12 months, as demonstrated in case 3 of the tentative agenda decision.

Despite the fact that this entity has performed as expected by its lender, meeting all of its contractual quarterly covenants, which are adjusted for the seasonality of its business, it would be required to classify its bank loan as current for 2023 Q3 and 2024 Q1. We do not believe that this presentation provides users of financial statements with useful information. Reclassification of the loan throughout the quarters indicates to users of financial statements that the entity's compliance with conditions imposed by its lender have changed in some way, which is incorrect. This effect will also obscure the effect of entities which have truly not complied with covenants, resulting in the lender having the right to demand immediate repayment.

We believe this effect would result in preparers providing non-GAAP or pro-forma measures to adjust for this effect, which is not a satisfactory outcome.

To evidence the prevalence of seasonality in particular sectors, we reviewed United States Census Bureau data, which summarises seasonality from 1992 to 2020 and projections into 2022. This information is available here. As an example, the seasonality factors for retail and food services in 2019 in the United States were as follows (2020 was not used due to the effects of COVID-19):



As can be seen, even at a highly aggregated level, seasonality factors range significantly from 0.879 in February to 1.125 in December, a band of 0.246. This demonstrates significant variation in sales from one point in the year to the next, which demonstrates the issue we have described above.

Cumulative Covenants – Financial Performance

We believe the amended standard does not provide sufficient guidance for preparers to determine how the standard should be applied to conditions relating to the entity's cumulative financial performance (e.g. profit, turnover, etc.).

The Basis for Conclusions to the amendments to IAS 1 include BC48E (**emphasis added**):

> *The Board considered whether to specify how management assesses an entity's compliance with a condition relating to the entity's cumulative financial performance (for example, profit) 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 because any single method could be inappropriate in some situations.***

Therefore, the Basis for Conclusions acknowledges that some form of adjustment is required to either the conditions relating to cumulative financial performance or the actual measure of cumulative performance, however, IAS 1 does not specify the manner of this adjustment.

For example, assume Entity A has a 31 December year-end and a bank loan that is repayable on 31 December 2030 unless Entity A fails to satisfy certain covenants. If Entity A fails a covenant test at any quarter end, then the loan is immediately repayable at the option of the lender. For the 2024-year, Entity A must comply with quarterly profit covenants, which are cumulative. For the 3, 6, 9- and 12-month periods ended 31 March, 30 June, 30 September and 31 December 2024 and 25, Entity A must have earned cumulative profits as follows:

- 3 months ended 31 March (Q1): CU 50,000
- 6 months ended 30 June (Q2): CU 110,000 (additional CU 60,000)
- 9 months ended 30 September (Q3): CU 125,000 (additional CU 15,000)
- 12 months ended 31 December (Q4): CU 190,000 (additional CU 65,000)

In setting these covenants, Entity A's lender understands that Q2 and Q4 are Entity A's most profitable quarters, and therefore sets the cumulative profit covenant accordingly.

It is not clear how the amendments to IAS 1 should be applied to this fact pattern as at each quarter end in 2024. BC48E suggests that an adjustment to either the cumulative performance or the condition used to test that performance may be required. We have demonstrated two possible approaches in applying the requirements of IAS 1 to this fact pattern, which produce different results as at 31 March 2024. Other approaches may be applicable as well.

Approach A

Entity A should consider whether the profit earned in Q1 2024 would satisfy all of the quarterly covenants to be tested in the next 12 months. Assuming the covenants noted above are the only ones to be tested in the next 12 months, and Entity A earned CU 55,000 of profit in Q1, then as at 31 March 2024, Entity A would apply IAS 1.72A and assess compliance as follows:

Covenant Period	*Profit requirement for that period in isolation*	*Does Entity A comply as at 31 March 2020?*
Q1 2024	CU 50,000	Yes
Q2 2024	CU 60,000	No
Q3 2024	CU 15,000	Yes
Q4 2024	CU 65,000	No
Q1 2025	CU 50,000	Yes

At 31 March 2024, Entity A does not comply with all conditions that will be required to be tested in the next 12 months (i.e. at the end of Q2 and Q4 in 2024), meaning that the bank loan is classified as current due to the fact that the entity does not have the right to defer settlement of the liability for at least 12 months as at 31 March 2024 (IAS 1.69(d) and 72A).

Approach B

Entity A should assess whether it has complied with the covenants that are required to be measured at its current reporting date, and consider whether its earnings projections for the period of 12 months from the reporting date would result in future covenant tests that are required to be carried out during that future period would be met.

For the three month period ended 31 March 2024, Entity A generated profit of CU 55,000. This is in excess of the profit required by the covenant, and so the test at the end of Q1 2024 has been met.

Entity A then considers its earnings projections for the four subsequent quarters to the end of Q1 2025. Assume that those projections indicate that Entity A will meet each of the covenant tests at the end of each calendar quarter for the period to 31 March 2025.

As Entity A complies with the current covenant conditions and is expected to meet all future covenants that are required to be met for a period of 12 months from the reporting date, the bank loan is classified as non-current.

We note that these types of cumulative covenant are very common. Consequently, in addition to reconsideration of the non-cumulative test that is dealt with in the tentative agenda decision, the Committee should also request the IASB to consider what further action should be taken in order to clarify how the amended requirements in IAS 1 should apply to conditions relating to cumulative measures of financial performance. Unless the requirements are clarified, we believe that there is significant risk of diversity in practice.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)7875 311782 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

February 15, 2021

IFRS Foundation
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Canary Wharf
London E14 4HD
United Kingdom

Dear Members of IFRS Interpretation Committee,

Re : Tentative Agenda Decisions –
Classification of Debt with Covenants as Current or Non-current

We welcome the opportunity to provide our comments on the Tentative Agenda Decision - "Classification of Debt with Covenants as Current or Non-current".

1. We had already acknowledged that there were some conceptual issues to the amendments of IAS1 which was issued in January 2020. We pointed out these conceptual issues of that amendments in our comment letter to Exposure Draft "Classification of Liabilities as Current or Non-current- Deferral of Effective Date" which was published in May 2020 by the IASB (see paragraph 19 of appendix A).

2. The IASB finalized that exposure draft as narrow scope amendments only for prioritizing comparability in January 2020 on the other hand the IASB had already recognized there were conceptual issues. In short, it resulted the IASB let conceptual issues remain intentionally. Therefore we agree with this TAD non-aggressively only as interpretation in light of the objective of that narrow scope amendments. However, as you all know it is not what we intend originally.

3. We believe that significant point is whether there is an enforceable obligation to require to be settled within twelve months at the end of reporting period rather than there is a right to defer settlement for at least twelve months after the reporting period. The specific condition to meet after the end of reporting period does not occur an enforceable obligation at end of reporting

period.

4. We believe the IASB should not have deferred the effective date of amendments to IAS1 even if during the Covid-19 as far as the IASB consider it is narrow scope amendments and sooner improvement for comparability as a result of long outstanding delay for amendments. The information about entity's liquidity and its comparability among entities is material for the users of financial statements during the Covid-19. It is clear that there is a contradiction in the postponement decision of the IASB in light of that objective.

5. We believe that the IFRS Interpretation Committee should make clear what intension and objective exist behind addressing these issues in the IFRS Interpretation Committee meeting regardless of no formal submission. According to paragraph 8.2 of Due Process Handbook revised in August 2020, it requires the submission from stakeholders for issuing agenda decision. And paragraph 7.6 of Due Process Handbook states that "*the Interpretations Committee is not seeking to create an extensive rule-oriented environment, nor does it act as an urgent issues group*". The abuse of agenda decision may raise doubts about the high-quality of IFRS standards.

6. It should be addressed in the IASB if the IASB intends to resolve conceptual issues for the amendments to IAS1. In that situation, the IASB should reopen the classification of liabilities as current or non-current project to much more ensure high- quality after the IASB would admit formally the amendments to IAS1 issued in January 2020 have conceptual issues.

We hope our comments will contribute to the forthcoming deliberations in the meeting of IFRS Interpretation Committee. Please feel free to contact us if you have any questions with respect to this letter.

Yours sincerely,

Masahiro Hoshino

Appendix A:

Our Comment Letter to the Exposure Draft "Classification of Liabilities as Current or Non-current-Deferral of Effective Date"

May 25, 2020

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United Kingdom

Dear Mr. Hans Hoogervorst and the IASB Board Members,

Re: Exposure Draft 2020/3"Classification of Liabilities as Current or Non-current-Deferral of Effective Date"

We welcome the opportunity to provide our comments on the Exposure Draft 2020/3" Classification of Liabilities as Current or Non-current-Deferral of Effective Date" (hereinafter referred to as "the ED").

1. We disagree with the proposal in the ED to defer the effective date of amendments to IAS1, *Classification of Liabilities as Current or Non-current*. We have a conviction that accounting standards should be developed based on a robust accounting theory to represent faithfully the financial position of entity as of a specific point and high-quality accounting standards themselves should not consider aggressively whether to give an extension, grace or moratorium for effective date with objective to encourage the entity to renegotiate agreements.

2. The backgrounds of our conviction above consist of following three reasons.
   - Contrary to the "Preface to IFRS Standards"
   - Impairing Comparability between the Entities
   - Long Outstanding Delay in the IASB's Clarification of IFRS Standard

3. We believe the “Preface to IFRS Standards” should be highly respected by each board member. And we believe that this issue is more than simply deferring the effective date of certain one narrow-scope amendments. In other words, it is extremely important issue to test whether each board member has true strong intent to commit to achieving the objective of the IFRS Foundation in the constitution of establishing international financial reporting standards that are of high quality, comparable and transparent or not.

4. We are also concerned that the IASB has a trend not to fully analyze every stakeholder’s voice in the world by shortened comment letter period recently[1]. In short, the IASB supposes to be amended naturally and shortens comment letter period intentionally. The IASB should explain why comment letter period of this ED is largely shortened than the previous Exposure Drafts which proposes to defer the effective date of certain standards.

Our detailed responses to the each question in the ED are accompanied in the following Appendix to this letter. It would be appreciated if you could refer to that Appendix with above our comments.

We hope our comments will contribute to the forthcoming deliberations in the ED. Please feel free to contact us if you have any questions with respect to this letter.

Yours sincerely,

Masahiro Hoshino
Certified Public Accountant of Japan

[1] For example, the IASB decided the comment letter period of Exposure Draft “Covid-19 Related Rent Concessions” published on April 24, 2020 is only 14 days.

Appendix:

Question
The Board proposes to defer the effective date of amendments to IAS1, *Classification of Liabilities as Current or Non-current*, to annual reporting periods beginning on or after 1 January 2023. Do you agree with the proposal? Why or why not?

5. According to the ED, we realized that the reasons to defer the effective date of amendments to IAS1 is due from the statements in paragraph BC2 of the ED such as "*The Board noted that the pandemic has created pressures that could delay the implementation of any changes in classification resulting from the application of these amendments. It could also delay the start and extend the duration of the renegotiation of loan covenants*".

6. We have a conviction that accounting standards should be developed based on a robust accounting theory to represent faithfully the financial position of entity as of a specific point and high-quality accounting standards themselves should not consider aggressively whether to give an extension, grace or moratorium for effective date with objective to encourage the entity to renegotiate agreements.

Contrary to the "Preface to IFRS Standards"

7. We believe that the IASB's reasons to defer the effective date above is contrary to the "Preface to IFRS Standards". Paragraph 13 of the "Preface to IFRS Standards" stipulates as follows.

> *The Board has no general policy of exempting transactions occurring before a specific date from the requirements of new Standards. When financial statements are used to monitor compliance with contracts and agreements, a new Standard may have consequences that were not foreseen when the contract or agreement was finalised. For example, covenants contained in banking and loan agreements may impose limits on measures shown in a borrower's financial statements. The Board believes the fact that financial reporting requirements evolve and change over time is well understood and would be known to the parties when they entered into the agreement. It is up to the parties to determine whether the agreement should be insulated from the effects of a future Standard, or, if not, the manner in which the agreement might be renegotiated to reflect changes in reporting rather than changes in the underlying financial condition.*

8. The "Preface to IFRS Standards" is the most underlying base of IFRS standards beyond the

Conceptual Framework for Financial Reporting. It should be highly respected. Therefore the IASB should not propose the delay of effective date without revising the "Preface to IFRS Standards" by only reason of the renegotiation of loan covenants. In other words, it might arise the issue on the due process or not align with the objective in the Constitution of IFRS Foundation.

9. The Constitution of IFRS Foundation stipulates its objective in paragraph 2 (a) as follows.

> *to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions.*

10. Moreover we can find the sentences in paragraph BC1 of the ED such as "*The Board noted that these amendments would result in some entities reclassifying debt from noncurrent to current, potentially affecting those entities' compliance with loan covenants. The effective date for the amendments was therefore set to allow affected entities enough time to renegotiate their debt covenants if necessary. The Board decided that an entity shall apply the amendments for annual reporting periods beginning on or after 1 January 2022 retrospectively*".

11. However we could not find these backgrounds in the Basis for Conclusions of the amended IAS1 which was issued January 23, 2020. If this is true, the IASB had already contemplate the possibility of renegotiation of agreement at the development of amended IAS1. In short, it already might be contrary to the "Preface to IFRS Standards".

Impairing Comparability between the Entities

12. According to the ED, the IASB only propose to defer the effective date but continue to permit to apply early the amended IAS1. In this situation, it could impair the comparability between the entities for long time. Therefore deferring the effective date could lead to not providing useful information on the entity's financial position to the primary user of financial statements. This also results in unintended consequence against the current encouragement of the IASB's consistent application activities.

13. Although the IASB justifies the delay for presentation of liabilities issue which is not related to recognition and measurement in the statement of paragraph BC3 of the ED, the information on presentation of liabilities during a time of significant disruption is extremely important for the

primary user of financial statements.

14. The amended IAS1 clarify only classification of liabilities as current or non-current. If the IASB defers the effective date by one year from 2022 to 2023. There are approximately 36 months until compulsory application from the originally date published in January 2020.

15. On the other hand, the IASB proposed 18-24 months from the date of publication with respect to the ED "General Presentation and Disclosures" which was published on December 17, 2019. It is apparent the contents of amended requirements on the ED "General Presentation and Disclosures" are much broader than the amended IAS1. Therefore the proposal of the ED to defer the effective date by one year is not understandable for stakeholders.

Long Outstanding Delay in the IASB's Clarification of IFRS Standard

16. This issue for classification of liabilities as current or non-current has been continuing to discuss in the IASB and the IFRS Interpretation Committee from originally as far back as July 2006. With respect to this issue, the IASB issued the Exposure Draft in October 2007 and amended IAS1 in April 2009. And again the IASB issued the Exposure Draft in May 2012 and in December 2015. Finally the IASB published the final standards as "*Classification of Liabilities as Current or Non-current*", which but is just only nothing more than clarification of requirements, in January 2020. Therefore comparability among entities has been impaired for approximately over at least 14 years. It is extremely long delay for as narrow-scope amendments.

17. On the other hand, the IASB proceed aggressively the amendments to IFRS17 project and Interest Rate Benchmark Reform project under current situation of Covid-19 pandemic. The development of IFRS17 also has been continuing to discuss for long time same as classification of liabilities as current or non-current project. We cannot understand why the IASB wants to proceed with difference treatments between classification of liabilities as current or non-current project and IFRS17 project, and IBOR project.

18. Moreover we do not interpret that classification of liabilities as current or non-current project is reopened at this ED, which propose to amend only on the effective date although we think IFRS17 project was reopened substantially by its Exposure Draft issued in June 2019. That is why the IASB tentatively decided the effective date of IFRS17 will be deferred from 2021 to 2023 in March Board Meeting.

19. Therefore we disagree with deferring the effective date unless the IASB reopens the classification

of liabilities as current or non-current project to much more ensure comparability after the IASB admits the amendments to IAS1 issued in January 2020 have conceptual issues.

Comment Letter Period

20. We believe that the IASB should explain why comment letter period of this ED is largely shortened than the previous Exposure Drafts which proposed to defer the effective date of certain standards. We summarize the comment letter period of which the previous Exposure Drafts and the ED published by the IASB proposed to defer the effective date as follows.

	Publication Date	**Comment Due Date**	**Comment Period**
IFRS9 (2009/2010)	Aug 4,2011	Oct 21,2011	78 days
IFRS15	May 19, 2015	July 3, 2015	54 days
IFRS10 and IAS28	Aug 10, 2015	Oct 9, 2015	60 days
This ED (IAS1)	May 4, 2020	Jun 3, 2020	**Only 30 days**

21. The Due Process Handbook of IFRS Foundation also was amended in February 2013 for the purpose of the increase in the minimum comment period for exposing the draft of a rejection of a request for an Interpretation request from 30 days to 60 days. This change responds to concerns that the Interpretations Committee is not receiving sufficient feedback on draft rejection notices.

22. We are concerned that the IASB is proceeding with discussions on the premise of amendments to IAS1 without prudent attentions, same as the Exposure Draft "Covid-19 Related Rent Concessions".

Think Ahead ACCA

Classification of Debt with Covenants as Current or Non-current (IAS 1)

Tentative agenda decision issued by the IFRIC in December 2020

Comments from ACCA
February 2021

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants, offering business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

ACCA supports its 227,000 members and over 544,000 students in 176 countries, helping them to develop successful careers in accounting and business, with the skills required by employers. ACCA works through a network of 110 offices and centres and 7,571 Approved Employers worldwide, who provide high standards of employee learning and development.

Through its public interest remit, ACCA promotes appropriate regulation of accounting and conducts relevant research to ensure accountancy continues to grow in reputation and influence. More information is here: http://www.accaglobal.com

Further information about ACCA's comments on the matters discussed here can be requested from:

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COMMENTS FROM ACCA

ACCA welcomes the opportunity to provide views in response to the IFRS Interpretations Committee (IFRIC) tentative agenda decision on the classification of liabilities as current or non-current. This has been done with the assistance of members of ACCA's Global Forum for Corporate Reporting.

We agree that Case 1 is a current liability.

Cases 2 and 3 are stating that conditions that must be met at a future date, must also be met at the reporting period end if this is a condition that could affect the classification of the liability. While the agenda decision would clarify the meaning of Paragraph 72A, it would seem to take the classification away from just conditions which existed at the end of the reporting period and include the impact of future events. There could be cases where the covenants are set at different levels at different dates to recognise a seasonal business. In Case 2 if the financial statements were approved after the condition was met in March would that alter the classification in the December financial statements?

We disagree with this tentative agenda decision. We consider that this matter should not be decided by IFRIC, but be referred to the IASB because the particular interpretation

- May not be consistent with other principles of IAS1
- is at odds with much current practice
- could have a very significant in terms of changing the classification of liabilities with impacts on the going concern basis of financial statements
- is based on Paragraph 72A which has not been subject to public consultation

Nutrien
Feeding the Future

February 15, 2021

Submitted electronically via ifric@ifrs.org

IFRS Interpretations Committee
IFRS Foundation
Columbus Building
7 Westferry Circus
London, E14 4H4
United Kingdom

Subject: Tentative Agenda Decision – Classification of Debt with Covenants as Current or Non-current (IAS 1)

Dear members of the IFRS Interpretations Committee ("Committee"),

This letter is submitted in response to the Committee's consideration of the implications of the Classification of Debt with Covenants as Current or Non-current. Nutrien Ltd. is the world's largest provider of crop inputs and services, with a market capitalization of approximately US $23 billion and its shares publicly traded on the New York Stock Exchange and the Toronto Stock Exchange. Nutrien has been applying IFRS since 2011, and reports in quarterly intervals.

We have reviewed the details of this tentative agenda decision and considered the impacts on our business and that of our stakeholders. In our view, the Committee's interpretation of paragraph 72A of IAS 1 as explicitly outlined in the fact patterns in Cases 1 through 3 of the tentative agenda could result in misleading reporting and/or unnecessary restructuring of debt facilities.

The Committee has interpreted IAS 1 paragraph 72A, which is a new paragraph that was not included in the ED 2015/1 that proposed amendments to IAS 1 and consequently, was not exposed for public comment. There is also no additional information provided in the Basis for Conclusion to the amendment to IAS 1 to sufficiently explain why this paragraph was added subsequent to the exposure draft.

In our view, the conclusions reached by the Committee in this tentative agenda decision are counter-intuitive and not obvious. As the Committee's interpretation will have widespread implications for all companies with debt, financial lending institutions, and could be subject to confusion by the user community, there should be more public exposure to this matter than issued in a tentative agenda decision only available for a 60-day comment period.

Debt covenants are agreements between a borrower and lender that impose rules established by the lender as a condition for receiving credit that stipulate how the business should run. Debt covenants protect the lender and are chosen based on specifics of the borrower's business and lender's risk tolerances. Often, lenders spend significant resources understanding the business, modeling cash flows and setting appropriate operating limits on the borrower. Covenants aren't meant to place unnecessary burdens on the borrower or hinder the operations of the business. Instead, they are informed by the lender's risk tolerance and determined to allow a pathway for the borrower to succeed. Lenders want borrowers to be successful because that improves their chances of getting the loan repaid and interest earned. We have concerns that if this tentative agenda decision is finalized without amendment, it may result in requirements to classify debt as current in situations that were not contemplated when negotiated between the lender or borrower. We are concerned this interpretation has the potential to undermine the borrower-lender relationship and impose potentially more stringent limitations on the business than were contractually agreed upon.

In our view, classification of debt as current is an inappropriate result in situations where its covenants are not contractually breached at the reporting period date, and there is no expectation by the company that a covenant will be breached at the time of the covenant is measured (specifically fact patterns in Case 2 and Case 3 where there is no expectation the covenant will be breach when tested). To most stakeholders, change in classification of long-term debt to a current liability infers that the event of default is imminent and outside of the control of management. In our view, this will be negatively received by the company's shareholders, analysts, suppliers, and employees, and could trigger cross-default in other agreements. This could impact a company's debt rating, increasing financing costs, and trigger early payment or current classification on other agreements. Suppliers may also require additional guarantees or letters of credit to conduct business. Debt classification as current has real cash consequences, in addition to being potentially confusing to users.

A likeness can be drawn between IAS 37 and this tentative agenda decision whereby an event of default is a 'obligating event'. IAS 37.17: "A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event." Until the obligating event has occurred (i.e. a covenant breach as agreed contractually by the lender and borrower), there are options within the control of the company to avoid any potential breach. If this tentative agenda decision is finalized as drafted, management's expectations regarding future compliance with future covenants will be disregarded. In our experience, whether through changes to the business or change to the agreement with the lender, there are options available to management until such time as the covenant is contractually breached.

Our revenues are seasonal, and we have large variability in our working capital throughout the year. We have strong concerns that the tentative agenda decision's interpretation of paragraph 72A of IAS 1 may lead to a reclassification of long-term debt at certain quarterly reporting dates, although, from an economic perspective, the covenant was arranged to consider this seasonal timing and the lender does not in fact consider a breach imminent. This decision may result in a cyclical reclassification between current and non-current, in spite of the lender acknowledging our historical trend of working capital changes. This artificial balance sheet volatility could be quite confusing to users of the financial statements and will not incrementally improve financial disclosure.

Nutrien
Feeding the Future

In Canada, it is not uncommon for covenants to scale into the future – to become more restrictive as time passes, even quarterly; for example, to fund a capital expansion. Financial returns from the expenditure are not immediate, and they will likely improve over time as the factory/process/machinery are optimized. The scaled covenants take into account the time difference between borrowing to capital spend, and then through to optimization. Requiring issuers to comply with future conditions at the end of the reporting date even if the lender does not test compliance until a later date would subvert the agreement with the lender. Further, if the debt is considered short-term, it may limit the availability of additional funds on the facility should the borrower need them.

This interpretation of the IAS 1 amendment will require many companies to 'open' their facilities for negotiation or to obtain waivers to avoid a balance sheet reclassification on adoption of the IAS 1 amendments, which may result in punitive restructuring charges or worse, reduction or cancellation of debt facilities. Further, we are concerned with the ability of lending institutions to grant waivers for over a 12-month period to meet compliance with IFRS. We acknowledge, over time, borrowers will likely adapt their agreements to ensure covenant measurement and compliance can adhere to this decision. However, in the interim, we feel imposing this decision may force borrowers to rectify their agreements and put them at a disadvantage, as well as incurring otherwise avoidable refinancing costs.

Instead, we strongly recommend to the Committee not to issue a final position in relation to the fact patterns and examples in the tentative agenda decision and to submit the matter for further review. As the amendments to IAS 1 are not effective until January 1, 2023, we consider that there is ample time for this matter to be further considered with due process.

We appreciate your thoughtful consideration of the views and recommendations provided in this letter. If you have any questions or need additional information, please do not hesitate to contact me (+14032257026).

Yours sincerely,

Janice Anderson

Janice Anderson CPA, CA
Director, Technical Accounting and Research Advisory Services

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February 15, 2021

Ms Sue Lloyd
International Accounting Standards Board
Columbus Building
7 Westferry Circus
London
E14 4HD

Dear Ms Lloyd,

Tentative Agenda Decision: Classification of Debt with Covenants as Current or Non-current (IAS 1)

Precision Drilling Corporation welcomes the opportunity to comment on the above Tentative Agenda Decision ("TAD"). Following discussions with members of our organization, our response summarizes our interpretation of the amendments to IAS 1 and concerns with the TAD conclusion regarding the classification of debt with covenants.

Our Interpretation of the Tentative Agenda Decision

Upon review of the amendments to IAS 1 and technical analysis provided in the TAD, we do not agree with the conclusions reached and do not believe there is an adequate basis for entities to determine how to classify loans with covenant conditions in all situations.

We agree with the principle that only rights and obligations existing at the reporting date should be considered when considering the classification of liabilities and acknowledge the estimation uncertainty and subjectivity of management's intentions or expectations of compliance of future conditions.

We agree that an entity shall classify liabilities as current when it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period. Per paragraph 72A, we acknowledge the right to defer settlement should exist at the end of the reporting period. However, the right to defer settlement at the reporting date must consider whether there is an obligation to comply with specified conditions at this same date. If at the reporting date, there is no obligation to comply with specified conditions, the right to defer settlement cannot be challenged.

Proposed paragraph 72A goes to on to state, "*the entity must comply with the condition at the end of the reporting period even if the lender does not test compliance until a later date*." We believe further clarification by The IFRS Interpretations Committee is required in relation to cumulative financial performance covenants. We are concerned by the interpretation of paragraph 72A as to establish the right to defer settlement and that the entity must comply with both the conditions at the current reporting date and those conditions to be tested at a date later to the reporting date.

We considered the fact patterns presented in Case 2 and Case 3 of the TAD. For Case 2, we believe the right to defer settlement is not subject to a condition at the reporting date as the condition does not come into effect until after the conclusion of the annual reporting period. For Case 3, the second part of the condition does not exist until a future date. As the contractual terms of the arrangement do not require the entity to comply with the higher ratio until a date after the reporting period, there is no settlement obligation at the reporting date. In the absence of this obligation at the reporting date, the liabilities should not be settled within a period of less than 12 months. In both Cases, the entity expects to comply with the conditions at the future test date.

We looked to BC48E for further clarification on an acceptable measure to the future conditions, "*however, the Board decided not to specify a method of adjustment because any single method could be inappropriate in some situations.*" We believe the lack of clear guidance will create inconsistent interpretation among entities, in particular, when the following situations arise:

- covenants assessing financial performance over a cumulative period beyond the end of the reporting period, but within twelve months of the reporting date;
- covenant ratios where inputs may be materially affected by profits and cash flows respectively between reporting date and the compliance test date;
- considerations for seasonal business and how this may affect how covenants and lending arrangements are structured; and
- non-financial covenants tested after the end of the reporting period, such as providing audited financial statements within a set period after the end of the reporting period.

Seasonality is of a particular concern in our industry as we have periods within the year where the level of our operations fluctuates with weather (i.e. our customers cannot access their locations during periods when the ground is too wet or when locations are in areas that are winter access only). Our debt covenants are constructed to accommodate this seasonality. The hypothetical covenant calculation does not contemplate changes in future covenants that were designed to accommodate seasonality.

In these situations, we believe the TAD omits consideration of the contractual terms of the lending agreement and does not fairly represent the arrangement. In our experience, covenants negotiated and established in good faith, weigh entity-specific considerations (including seasonality of businesses) and the specific purpose of the contract. We believe the interpretation of the IAS 1 amendments supersedes the intention and legal enforcement of lending arrangements.

Notwithstanding, we continue to believe that if the entity expects that future covenants will be breached, appropriate disclosure is required under IAS 1 and IFRS 7, discussed below.

Implications and Timing of these Amendments

In addition to an increased frequency of debt being classified as current in situations when lenders do not have rights to demand repayment and where neither lenders nor entities expect the loan to be classified as current, we believe entities will be adversely and unfairly impacted by these amendments.

With the increased frequency of debt being classified as current in situations when lenders do not have rights to demand repayment, we believe this will often draw undeserved attention to debt balances when there is minimal liquidity risk. We believe the standards have established appropriate disclosures when risk of covenant non-compliance is present, for example, within IAS 1.25-26 in respect of going concern and IFRS 7 with respect to liquidity risk.

From a practical perspective, we believe proceeding with these amendments and interpretations may create unnecessary friction between entities and lenders. These amendments will create incremental costs for entities in obtaining grace period waivers for the sole purpose of maintaining non-current classification wherein no actual breach of conditions has occurred or is expected to occur, if waivers can even be obtained at all.

Finally, we believe the timing of the TAD comment period to be inappropriate as it overlaps with the height of the financial reporting period for calendar year-end companies. We believe our views to be consistent with that of our industry peers and that due to the timing of the comment period and the challenges posed by the on-going COVID-19 pandemic that insufficient time and attention has been provided for our peers to provide comments on the amendments.

We believe the Committee should not finalize the TAD and refer the issues identified to the International Accounting Standards Board. We believe that the amendments need to be reconsidered before they become effective. In addition, we believe there are sufficient grounds to extend the comment period and provide entities additional time to consider the potential impact and effects these amendments will have on their financial statements and lending arrangements.

If you have any questions in relation to this letter please do not hesitate to contact Carey Ford, Senior Vice President and Chief Financial Officer (713-435-6100).

Regards,

Carey Ford
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RÉPUBLIQUE FRANÇAISE
Liberté
Égalité
Fraternité

AUTORITÉ DES NORMES COMPTABLES

Paris, 15 February 2021

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PDC n°6

Mrs Sue Lloyd
Chair of the IFRS Interpretations Committee
7 Westferry Circus, Canary Wharf
London, E14 4HD
United Kingdom

December 2020 *IFRIC Update*—Feedback on the Tentative Agenda Decisions

Dear Sue,

I am writing to you on behalf of the Autorité des Normes Comptables (ANC) to express our views on two IFRS Interpretations Committee's (Committee) Tentative Agenda Decisions (TAD) published in December 2020.

There are two appendices to this letter:

- Appendix A sets out our comments in relation to the TAD on *Classification of Debt with Covenants as Current or Non-current*; and
- Appendix B sets out our comments with regard to the TAD on *Attributing Benefit to Periods of Service*.

Should you need any further information, please do not hesitate to contact me.

Yours sincerely,

Patrick de Cambourg

Patrick de Cambourg

Appendix A—Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)

This appendix discusses separately (i) our comments on the technical analysis included in the TAD and (ii) our feedback on whether the requirements in IFRS Standards underpinning this analysis provide useful information.

- **Committee's technical analysis included in the TAD**

We agree with the Committee's technical analysis and tentative conclusion that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine how to classify the loan as current or non-current in the three fact patterns described in the TAD.

- **Reservations about whether the requirements in the amendments to IAS 1 (amendments) result in useful information in the fact patterns described in the TAD**

We think this TAD undoubtedly improves the understanding of the amendments among stakeholders who now have a common and clear understanding of how those amendments will apply in specific circumstances and thus, how they will affect an entity's statement of financial position. Having said that, the TAD also sheds light on what we view as serious flaws of those amendments. We question whether the requirements in paragraph 72A of the amendments that support the Committee's conclusion for cases 2 and 3 provide useful information.

We think this question is worth being asked considering the likely far-reaching effects the amendments may have for an entity—this is because the classification of liabilities as current or non-current usually affects the assessment of an entity's liquidity and thus, (i) its ability to access debt,(ii) the cost of its debt and (iii) generally its relations with external parties (such as suppliers).

We also consider this question as relevant considering the fact that the outcome of applying the requirements in paragraph 72A came as a real surprise for many stakeholders, acting in good faith. We identified several reasons for this surprise:

- entities have not yet first applied the amendments—they are required to do so for annual reporting periods beginning on or after 1 January 2023—and many of those entities have not even started to assess the likely effects of those amendments.
- the principle underlying the requirements in paragraph 72A was exposed in the ED/2015/1—*Classification of Liabilities* (ED) but as part of its Basis for Conclusions and in a somewhat elliptical manner. As the feedback on the ED indicated[1], there were differing views about how an entity would apply this principle to situations identical, or similar to, those described in the TAD. The final wording in paragraph 72A may improve clarity about the IASB's intentions but, in our view, remains quite challenging to understand without illustrative examples. We also note that the agenda papers the Board considered during its deliberations never clearly illustrated what the implications of paragraph 72A would be in the circumstances described in cases 2 and 3 of the TAD.
- the wording of this paragraph may imply that the requirements only apply when an entity has an obligation at the reporting date but is able to determine whether it meets this obligation only at a later date—for example, the entity has a covenant at the reporting date but compliance with that covenant is verified by reference to the audited financial statements issued at a later date.
- the Basis for Conclusions on the amendments does not, in reality, much comment on the requirements in paragraph 72A. Paragraph BC48E includes specific developments but only in relation to specific circumstances. We reiterate the role of the Basis for Conclusions that we consider as of high importance to help improve a common understanding of the IASB's intentions and accordingly, of the requirements in IFRS Standards.
- the outcome of applying the amendments is so 'counter-intuitive' in some circumstances that stakeholders still question whether the requirements in the amendments faithfully reflect the IASB's intentions.

We also note that some stakeholders already had raised concerns in their comments letters on the ED/2020/3—*Classification of liabilities as current or non-current—Deferral of effective date* published in May 2020 about the differing views on how an entity would apply the amendments to fact patterns similar, or identical to, those discussed by the Committee in the TAD[2]. We think this is additional evidence that the amendments might not have

[1] See in particular paragraph 29 of Agenda Paper 12B for the December 2015 IASB meeting.

[2] This is explained in paragraphs 16–19 of Agenda Paper 29A for the June 2020 IASB meeting. Paragraphs 18 and 19 of this Agenda Paper explain that '…*as stated in paragraph BC5 of the Exposure Draft, the [IASB] did not propose any changes to*

been entirely clear for a number of stakeholders, and accordingly that the outcome of the TAD may conceivably be a surprise for those stakeholders.

We have strong reservations about whether the requirements included in paragraph 72A result in information that is relevant and faithful in cases 2 and 3 of the TAD. The paragraphs below set out a summary of our reservations.

- **There are valid questions about whether the requirements in paragraph 72A faithfully reflect contractual rights and obligations**

The requirements in paragraph 72A result in an entity assessing at the reporting date whether it complies with the conditions that are *contractually* due to be tested at a subsequent date. If the entity does not comply with those conditions at the reporting date, it classifies the loan as current in its statement of financial position at this date. We strongly question whether those requirements faithfully reflect the rights and obligations specified in the loan arrangements described in cases 2 and 3:

- in case 2, the entity has only one covenant that is tested 3 months later. In this case, there is *no* obligation with which the entity has to comply at the reporting date—the covenant cannot contractually be breached at the reporting date, it can only be breached 3 months later. The requirements in paragraphs 72A result in an entity reflecting a 'virtual covenant breach' in its statement of financial position at the reporting date.
- in case 3, the entity does meet, at the reporting date, the covenant that is contractually due to be tested at this date—the entity abides by the obligation existing at this date. However, the entity does not yet meet the covenant that is contractually due to be tested 6 months later. Here again, the requirements in paragraphs 72A result in an entity reflecting a 'virtual covenant breach' in its statement of financial position whereas the entity explicitly complies with the obligations set in the loan arrangement.

In both cases, we note that (i) the lender has no right, at the reporting date, to ask for the repayment of the loan before the contractual date and (ii) the entity has no obligation to redeem it at this same date. A virtual covenant breach arises only because the entity performs a hypothetical covenant test.

The requirements in paragraph 72A result in an entity continuously assessing whether it complies with covenants despite the fact that the entity and the lender have contractually agreed to check such compliance at discrete points in time. In other words, we think the IASB has—consciously or unconsciously—embedded in paragraph 72A the 'creditor's protection argument' whereby an entity's right to defer settlement is implicitly conditional on continuously complying with the conditions specified by the lender even if those conditions are tested on specified date[3]. We recognise the 'prudential' merit of that argument but note it creates rights and obligations that are not specified in the initial contract.

- **Those requirements ignore the 'intended design of the covenants' and thus, may result in information that is not relevant**

The requirements in paragraph 72A result in an entity assessing at the reporting date whether it complies with the conditions that are due to be tested at a subsequent date, *solely on the basis of data observed at the reporting date*.

This fundamentally disregards some essential aspects that the parties considered when they agreed on the contractual terms. The timing for the covenant tests and the target values assigned to those tests usually reflect the entity's specific facts and circumstances. In other words, neither the dates for testing nor the target values are defined at random—they reflect the changes both parties expect in the entity's financial performance, position or liquidity by the testing dates. For example,

- in case 2, the parties may have agreed to test the covenant at the end of March because the entity's business is seasonal; and
- in case 3, both the testing dates and the target values assigned to the tests might have agreed as such because the entity has a seasonal business, or is in a recovery situation, or is launching a new activity or is in a start-up phase.

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the amendments issued in January 2020 other than the deferral of the effective date. Therefore, considering implementation questions would go beyond the scope of the proposal in the Exposure Draft and could delay the operational relief that the proposed deferral is intended to provide. Consequently, [the staff] do not propose to address these implementation questions as part of this project. However, [the staff] will consider whether further clarification of the Amendments to IAS 1 is required'.

[3] Paragraphs 18–23 of Agenda Paper 12B for the February 2016 IASB meeting explain this argument. We note this was the staff's view and accordingly, that this view does not necessarily represent the Board's view.

In both cases, (i) bringing forward the covenant test at the reporting date and (ii) requiring the entity to compare the covenant's target value with the data observed at the reporting date, result in comparing things that cannot be fairly compared. In other words, we think the amendments require an entity to perform a hypothetical test using data that are inconsistent with each other—the entity is required to 'compare apples and oranges'.

The classification the entity would apply to the loan throughout an annual period adds to our reservations about the approach retained by the IASB. If we assume that in cases 2 and 3 the entity meets the covenants tested after reporting date, the entity would first classify the loan as current at the reporting date and would then reclassify this same loan as non-current when then entity tests the subsequent covenants. Consequently, the entity would reverse the classification of the loan during subsequent reporting periods. An entity that has a seasonal business would make that reclassification continuously. In our view, this obfuscates the understanding of the entity's statement of financial position and thus, is unlikely to provide relevant information.

- **The requirements in paragraph 72 need to be revisited**

We support the thrust of this standard-setting project. The lack of clarity of the existing requirements in IAS 1 has created diversity in the reporting practices and, by doing, might have obfuscated the understanding of an entity's liquidity. Accordingly, there is a compelling case for standard-setting.

Having said that, we think the approach the IASB has retained for covenants that are to be tested after the reporting date will result in an outcome that many view as counter-intuitive and accordingly, is unlikely to provide useful information about an entity's financial position.

Paragraph 69(d) of IAS 1 currently states that '*an entity shall classify a liability as current when* […] *it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period…*'. We understand, on the basis of public comments and observations, that the IASB tried to make the 'unconditional right' concept operable. Applying the existing requirements in paragraph 69(d) of IAS 1, some may indeed think that an entity would be required to classify *any* loan including covenants that are to be tested after the reporting date as current at the reporting date. This is because the entity 'earns the right' to defer the settlement of the loan for at least twelve months only when the entity successfully performs the covenant test—in other words, the existence of a covenant test after the end of the reporting period might make it impossible for an entity to conclude it has an unconditional right to defer settlement for at least twelve months. We agree that an entity might reach that conclusion reading the existing requirements in paragraph 69(d) in isolation but there are valid questions about whether the resulting classification would provide useful information.

Thus, we appreciate the IASB's efforts to amend the existing requirements by removing the word 'unconditional' and setting a rule for when a right to defer the settlement of a liability exists when that liability is subject to conditions tested after the reporting date. We also appreciate the fact that the IASB tried to develop an approach that entities could easily implement—entities are required to test the covenants using data observed at reporting date and thus, do not need to develop estimates about the data they expect to observe at a later date.

However, we think that a practical outcome has been reached at the expense of useful information and accordingly, that the standard-setting approach underlying paragraph 72A is not appropriate. Simplicity will not make up here for the detrimental consequences of the amendments on useful information. Accordingly, we think the Committee should recommend the IASB to (i) publicly consider the feedback on the TAD and (ii) assess whether to add a narrow-scope standard-setting project to the work plan. In doing so, the IASB might wish to reach out to users to check whether paragraph 72A really cater for their information needs. We think any standard-setting could be limited to reconsidering the requirements in paragraph 72A.

We have identified two possible approaches the IASB may wish to consider if it were to undertake standard-setting:

- applying Approach A, an entity would be required to test, at the reporting date, whether it complies with the conditions that are contractually due to be tested at a later date, within the next 12-month period. In doing so, the entity would test those conditions using estimated data it expects to observe when the conditions are contractually due to be tested. In other words, the entity would assess, at the reporting date, whether it *expects* to comply with those future conditions based on its best estimates. In ANC's view, this approach would respect the 'intended design' of the covenants. It would also be consistent with the approach that underpins requirements in many other IFRS Standards such as IAS *36 Impairment of Assets*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers*, IFRS 16 *Leases* or in IAS 1 itself (for example when an entity assesses whether it is able to continue as a going concern applying paragraph 25 of IAS 21). Applying this approach, an entity would also be required to provide information about key assumptions and sources of estimation uncertainty, in particular in 'close call' situations.

- applying Approach B, an entity would determine the classification of the liability only on the basis of the conditions that are contractually due to be tested at the reporting date. In doing so, an entity would not test, at the reporting date, whether it complies with the conditions that are due to be tested at a later date. In ANC's view, this approach would strictly reflect the contractual rights and obligations and would be easy to implement. Applying this approach, an entity would also be required to provide information about the conditions that are due to be tested after the reporting period—ANC observes that some entities already provide such information when applying the existing requirements in IAS 1.

Appendix B––Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)

We do not entirely agree with the Committee's analysis and tentative conclusion as set out in the TAD. We think that, in the very specific fact pattern described in the submission, the Committee's tentative conclusion is a *possible* view and that an alternative analysis exists.

The TAD specifies that '…[*t*]*he Committee's conclusion aligns with the outcome set out in Example 2 illustrating paragraph 73, which is part of IAS 19*'. We disagree with this statement. We think that the Committee's tentative conclusion only aligns with an excerpt from the above-mentioned example (example 2 in this letter) but not with the example in its entirety. As the Committee's public discussions indicate, the Committee 'crosschecked' its conclusion retaining only a feature of the plan described in this example and that is reproduced in paragraph 28 of Agenda Paper 3 for the December 2020 Committee's meeting—'*A plan pays a lump sum retirement benefit of CU2,000 to all employees who are still employed at the age of 55 years after twenty years of service*…'. However, we think the Committee's ignored another feature of the plan of the example that is: '… *or who are still employed at the age of 65, regardless of their length of service'* (alternative scenario in this letter).

Example 2 illustrates the case of employees who join before the age of 35 and specifies that for those employees *'...service first leads to benefits under the plan at the age of 35 (an employee could leave at the age of 30 and return at the age of 33, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 55 will lead to no material amount of further benefits. For these employees, the entity attributes benefit of CU100 (CU2,000 divided by twenty) to each year from the age of 35 to the age of 55…*".

Example 2 also illustrates the circumstances in which an employee who joins at the age of 55. In those circumstances, we note that such an employee could leave at the age of 57 and return at the age of 60, *with no effect on the amount or timing of benefits*. Instead, we observe that the benefits are only conditional on the employee being employed at the age of 65—accordingly, for employees who join after the age of 55, service before the age of 65 does not lead to any benefits before the age of 65. Applying the Committee's tentative analysis in the TAD, this would result in the entity's obligation to provide benefits arising only when the employee reaches the age of 65 and thus, in the entity recognising the benefit of CU 2,000 when the employee is 65. However, example 2 concludes otherwise and specifies that for such an employee'…*the entity attributes benefit of CU200 (CU2,000 divided by ten) to each of the first ten years'*.

We think essential for the Committee to ensure that, and explicitly explain in any agenda decision, why its analysis tallies with example 2 in its entirety. This is because the Committee's analysis of the requirements in IAS 19 may have widespread effects. In this respect, we note that post-employment benefit plans that entitle employees to receive a retirement benefit when they reach the retirement age provided they are still employed by the entity at that time are common. Some of those plans specify that the benefits may be capped at an amount that is based on a given number of consecutive years of service.

We think that attributing retirement benefit from the date the employee starts working with the entity until the retirement date—regardless of whether that is longer than 16 years—is also an acceptable conclusion for the particular defined benefit plan as described in the submission. This is because:

- when the benefit is a direct consequence of the work contract as supplemented by relevant labour law, the employer incurs an obligation from the employment date onwards, even when the benefits only vest on the date of retirement—or to use the words of paragraph 70(a) of IAS 19, even if the benefits are 'conditional on further service'. If the employees complete all their career with the employer that initially hired them, then the employer is obliged to pay the benefits and only factors outside the employer's control (such as resignation or death) would relieve the employer from that obligation. Despite the fact that an employee joining at 25 will need to work 40 years (assuming that the retirement age is 65) to earn the same level of benefits as an employee joining at 45 who will only have to work for 20 years, each year of service of that employee reduces the amount of future service that the employee will have to render before becoming entitled to the post employment benefit. This suggests that it is appropriate to allocate a service cost for all service periods from the hiring date to the vesting date in accordance with paragraph 72 of IAS 19.

- attributing the ultimate cost of the post-employment benefit over the employees' entire career would also faithfully reflect the underlying economics, ie the average full annual payroll cost of the employee joining at 25 is less than that of the employee joining at 45 because it takes him or her 40 years to vest in the same amount of benefits whereas the employee joining at 45 who will earn the same amount of benefits in only half the period of time (20 years versus 40 years).

- the alternative scenario in example 2 also supports, in our view, that conclusion.

Accordingly, we recommend that the Committee develop further its analysis before finalising the TAD and consider the rationale and merits of the alternative conclusion based on example 2.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

(Established by Act of Parliament No. 15 of 1965)

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Registrar/Chief Executive
AHMED M. KUMSHE (PROF.), FCA

February 8, 2021.

ICAN/CP/R&T/FEB8/2020

IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD.

Dear Sir,

Re: Classification of Debt with Covenants as Current or Non-current (IAS 1)

Please find below our comments on the above-named Tentative Agenda Decision.

Conclusion:

In all three fact patterns described in this agenda decision, the Committee concluded that the entity is required to classify the loan as current because the entity does not have the right at the end of the reporting period (31 December 20X1) to defer settlement of the loan for at least twelve months after the reporting period.
In reaching its conclusion, the Committee noted that the entity's expectation that it will meet the condition tested after the reporting period does not affect its assessment of the criterion in paragraph 69(d) of IAS 1. Applying paragraphs 69(d) and 72A of IAS 1, the entity's right to defer settlement of a liability for at least twelve months after the reporting period must exist at the end of the reporting period.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for the entity to determine how to classify the loan as current or non-current in the three fact patterns described in the agenda decision. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Response:

We agree with the Committee's conclusion that the principle and requirements in IFRS Standards provide an adequate basis for the entity to determine how to classify the loan as current or non-current in the three fact patterns described in the agenda decision. We also believe that the tentative agenda decision provides further clarification on how entities should account for classification of debts on account of breach in the debt covenant.

We thank you for giving us the opportunity to contribute to the Agenda Decision and we are available should there be need for further clarification.

Yours faithfully,

For: Ahmed M. Kumshe (Prof.), FCA
Registrar/Chief Executive

February 11th 2021

International Financial Reporting Interpretation Committee

7 Westferry Circus

Canary Wharf

London E14 4HD

United Kingdom

Dear IFRIC members,

Tentative Agenda Decision – *Classification of Liabilities as Current or Non-current*

The Israel Accounting Standard Board welcomes the opportunity to comment on the IFRIC's Tentative Agenda Decision, *Classification of Liabilities as Current or Non-current*. This letter sets out the views that were raised by the Israel Accounting Standards Board members.

We welcome the IFRIC's discussion concerning the Amendment to IAS 1 *Classification of Liabilities as Current or Non-current* in order to achieve better uniformity in the application of the Amendment to IAS 1.

One of the objectives of the Amendment to IAS 1, was to clarify that management's intentions or expectations should not affect the classification of a liability as current or non-current and we agree with that principle. We agree that intention or expectation of management to roll-over an obligation should not affect the classification of the liability, but rather the entity's right as at the reporting date. Yet, in our opinion, the tentative agenda decision and possibly even the Amendment to IAS 1 itself go far beyond that, as further explained below.

We believe that the interpretation of the amendment to paragraph 69(d) and especially the addition of paragraph 72A are far-reaching and have wide consequential effects. In our opinion, it is difficult to support such an interpretation when the Amendment to IAS 1 did not include an amendment to paragraph 74. Paragraph 74 refers to a "breach of a condition of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand". According to the IFRIC's tentative agenda decision, neither a breach of a condition nor the effect that the liability becomes payable on demand is necessary for the classification of such a long-term loan as a current liability. Instead, a possible and uncertain breach of a condition that will be tested at a future date is enough to trigger classification of that liability as current.

We believe that such an interpretation and possibly even the Amendment to IAS 1 itself contradict the legal agreements made between the entity and the lender that set a future date for testing a condition rather than a current one. The reasons for setting a future date for testing a condition can be diverse and might include:

(a) a developing entity that is required to meet in the future covenants that are gradually stringent in accordance with the expected growth of the entity,

(b) an entity that initiates a recovery plan and is therefore required to meet in the future covenants to demonstrate the plan's success and the ability of the entity to repay the loan when due,

(c) an entity that had bad results in the last reporting period and therefore the lender requires meeting a covenant in a future date to show the entity has overcome the difficulties and will be able to repay the loan when due.

The tentative agenda decision means that the future date covenant agreed between the entity and the lender must be met not only on that future date, but continuously from the date the liability is recognised up until that future date. Furthermore, if the arrangement sets out future covenants that are gradually stringent (as illustrated in case 3), according to the tentative agenda decision the entity is required to meet the more stringent covenant than the one agreed with the lender for that date in order to classify the liability as non-current, ie the covenant at the reporting date is substantially ignored. Such an interpretation does not reflect the parties' intentions as set out in the liability's arrangement. If that were the parties' intentions, the parties could have set out a continuous covenant or different testing dates for that covenant.

Such an interpretation would require entities to frequently contact the lender in order to receive a waiver for a covenant that will be tested in a future date and therefore was not yet breached. The waiver that is required for the classification of the liability as non-current is required for all periods between the first reporting period following the loan arrangement until the covenant's future testing date. We believe that such a waiver is inherent in the agreement between the parties, ie that is the reason why a covenant was required to be met at a future date rather than at a current one. Such a requirement is impracticable.

The tentative agenda decision and the Amendment to IAS 1 relate only to balance-sheet conditions. In Israel, covenants that relate to the entity's cumulative financial performance (for example, profit) and covenants that relate to the entity's equity are very common. The Board noticed in paragraph BC48E that "…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. As a consequence, it is unclear how to test covenants relating to the entity's cumulative financial performance. Furthermore, testing such covenants in entities having seasonal activities and in developing entities for periods different than the ones set out in the arrangement could create distortions. For example, if a loan arrangement of an entity having a seasonal activity prescribes a cumulative profit covenant for the second and third quarters of 2021, testing that covenant on December 31st 2020 according to the third and fourth quarters of 2020 profit would not reflect the condition meant to be tested by the arrangement. Another example is a developing entity that its loan arrangement requires meeting a future yearly sales target. Testing that condition based on any past period would not reflect the parties' intentions and understanding that such a target could be met only in the future. Those complexities arise similarly for covenants that require specified equity or equity ratio.

In light of all of our comments and difficulties described above, we do not support the conclusion in the tentative agenda decision and believe that the IFRIC should reconsider it.

If the IFRIC's conclusion is unchanged, we believe that the IFRIC should consider referring the issue back to the Board to reconsider the Amendment to IAS 1. We would like to mention that the Exposure draft to this amendment, published on February 2015, did not include the addition of paragraph 72A (especially the last sentence in paragraph 72A). In September 2019, the Board decided not to re-expose the proposed amendments to IAS 1 and therefore, other parties including us did not have the opportunity to comment on those new provisions. As can be clearly understood from our letter, the changes made to the 2015 Exposure draft and the IFRIC's tentative agenda decision significantly change the way currently entities in Israel classify their liabilities as current/non-current. Therefore, in our opinion, the due process should have included re-exposing the proposed amendments to IAS 1 prior to the issuance of the final Amendments to IAS 1.

We appreciate the opportunity to provide our comments.

Sincerely,

Dov Sapir, CPA, Chairman

Israel Accounting Standards Board

SURGE
ENERGY INC

2100, 635 – 8th Avenue SW Calgary, AB T2P 3M3

Attn: Sue Lloyd
Chair of the IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Ms. Lloyd,

Surge Energy ("Surge") is a publicly traded Canadian oil and gas producer that reports under IFRS and is subject to quarterly reporting requirements. We are writing to provide comments on the fact patterns released to clarify the amendments to IAS 1 "Classification of Liabilities as Current or Non-current", effective for annual reporting periods beginning on or after 1 January 2023.

Surge is concerned that in practice, the amendments create a hypothetical covenant test which may result in our debt being classified as current even if we are not likely to breach a loan covenant that will be tested at a future date. This is problematic because if debt is classified as current but there is not a subsequent covenant breach, the application of the standard will result in a material misalignment between the presentation of debt in our financial statements and the actual outcome of the conditions specified in our lending agreements. The inconsistency will result in confusion for users of the financial statements and ultimately make financial statements less reliable. We feel strongly that our company and the users of our financial statements, along with other oil and gas companies in Canada, will be negatively impacted by the amendments.

The amendments ignore the seasonality of the oil and gas industry resulting in a high likelihood of misalignment between the financial position of the entity as at the reporting date and the future date of the compliance test.

Debt to EBITDA is a common financial covenant in the loan agreements of oil and gas producers and the calculation is heavily impacted by the seasonality of the industry. Debt levels are higher during capital intensive periods (typically winter and summer months when companies can access their properties to conduct drilling programs). Debt levels then decrease as production from seasonal drilling programs is brought online and the assets begin generating earnings. Earnings or EBITDA of oil and gas producers are also impacted by seasonality as oil prices and Canadian differentials are heavily impacted by the summer driving season and refinery maintenance season in the fall.

In practice, this seasonality will 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. The covenants within the debt agreement are structured in contemplation of this seasonality however, the hypothetical covenant test does not. This will introduce an unnecessary element of volatility to our balance sheet that does not reflect the underlying contractual arrangement with the lenders.

SURGE ENERGY INC

2100, 635 – 8th Avenue SW Calgary, AB T2P 3M3

If we do not meet the condition for compliance of a future covenant as at a quarterly or annual reporting date, we will be required to classify our debt as current. There is no ability to seek remedy from our lender(s) because a lender will only provide a waiver for an actual breach of a loan covenant and per the contractual terms of the loan agreement, there will not be a covenant breach as the compliance test will occur in the future.

This will result in misalignment between the classification of the debt on the financial statements versus the contractual terms of the loan agreement. The financial statements will indicate that a loan is current however the lender would not have the contractual right to demand repayment as no covenant breach has occurred. As such, we as the borrower, will not have a contractual obligation to settle the outstanding loan balance at the reporting date. This misalignment will require additional disclosure in our financial statements and regulatory filings to explain the inconsistency to readers.

The classification of debt to current on the statements due to a hypothetical covenant breach may have other unintended negative consequences such as cross default on other debts potentially causing more debt to be classified as current even if it is not subject to similar financial covenants. Our suppliers may view the classification of debt to current as a going concern issue and they may stop providing goods and services or they may institute very burdensome credit conditions, all of which could make it more difficult for us to operate.

Further, the classification of debt as current in a manner that does not conform with the nature of the contractual arrangement (due to the application of the hypothetical covenant test) will likely result in the need to include additional non-GAAP measures in our public disclosures. The inclusion of additional non-GAAP measures also risks increased confusion for our users and increases the associated complexities of complying with relevant securities regulations.

The standard as contemplated, will likely require us to work with our lenders to potentially remove commonly accepted financial covenants from our loans. If lenders can no longer rely on commonly accepted covenants, such as debt to EBITDA ratios, they are likely to conclude that they are exposed to additional risk and may want to be compensated with higher interest rate grids, which would have negative financial impacts on our cash flows.

Thank you for the opportunity to provide our feedback. If you wish to discuss our concerns further, please do not hesitate to contact me.

Sincerely,

Jared Ducs

Jared Ducs
Chief Financial Officer

email: jducs@surgeenergy.ca
phone: + 1 (403) 930-1046