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Summary of the comment letters received by the IFRS Interpretations Committee on the Classification of Liabilities as Current or Non-current, Amendment to IAS 1

- 1 This paper is prepared to inform EFRAG TEG about the comments received by the IFRS Interpretations Committee (IFRS IC) from European constituents with regards to the *Classification of Debt with Covenants as Current or Non-current*. The technical discussion and decision making with regard to the FEA is intended to take place after the IFRS IC discussion (which is expected for the April IFRS IC meeting).
- 2 Based on the comments received by the IFRS IC on its tentative agenda decision on the *Classification of Debt with Covenants as Current or Non-current*, the EFRAG Secretariat has developed a summary of the comment letters received from European constituents. In addition, a summary of the comment letters received from International Organisations and large audit firms is provided as the response of those constituents might be relevant for Europe.

Structure of the paper

- 3 This comment letter analysis contains:
 - (a) Background;
 - (b) Summary of European and International organisations including big audit firms' respondents' views;
 - (c) Appendix 1 – List of European respondents;
 - (d) Appendix 2 – List of accounting and auditing international associations; and
 - (e) The comment letters can be found using the following [link](#).

Background

- 4 The amendments were issued because of an apparent contradiction between IAS 1 paragraph 69 (d) and paragraph 73. Paragraph 69 (d) of IAS 1 *Presentation of Financial Statements* requires an entity to classify a liability as current if the entity 'does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period'. Paragraph 73 requires an entity to classify a liability as non-current if the entity 'expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility'.
- 5 The IASB adjusted paragraph 69 (d) and deleted the word "unconditional" and added that the right must exist at the end of the reporting period. Paragraph 72A was added to further specify the principle in paragraph 69(d) and paragraph 73 was amended. Some other following paragraphs were amended as well.
- 6 The ED was issued in 2015. The project was discussed in several IASB meetings but paused for a certain period while finalising the work on the framework. EFRAG

TEG members can find the ED [here](#) and the final amendments in the following [link](#). When comparing the ED and the Final Amendments mainly paragraph 72A was added (which further specify paragraph 69 (d)) and paragraph 73 was changed into a more principle based approach.

- 7 At its [April 2016](#) meeting, the IASB decided that the remaining redeliberation's of the comments received would be held back until after the IASB has redeliberated the definitions of assets and liabilities in the Conceptual Framework exposure draft.
- 8 Amendments to IAS 1 were issued in January 2020, effective for annual reporting periods beginning on or after 1 January 2022. The Amendments improve existing requirements and could result in companies reclassifying some liabilities from current to non-current, and vice versa; this could affect a company's loan covenants.
- 9 In response to the covid-19 pandemic, the IASB provided entities with more time to implement any classification changes resulting from the Amendments by deferring the effective date by one year to annual reporting periods beginning on or after 1 January 2023.
- 10 Following the amendments, the IFRS IC were informed that stakeholders could find it difficult to determine whether it has 'the right to defer settlement' when a long-term liability is subject to a condition (for example, a debt covenant) and the borrower's compliance with the condition is tested at dates after the end of the reporting period.
- 11 In December 2020 the IFRS IC provided [additional insights](#) into how the amendments would apply in different circumstances. A [Tentative Agenda Decision](#) (TAD) analysed three fact patterns.¹ The IFRS IC concluded in all three examples to classify the liabilities as current² and not to add the issue on its agenda. The consultation period has been open for comments until 15 February 2021.
- 12 EFRAG TEG discussed the impact of TAD that were discussed in the IFRS IC meeting of December 2020 on the Final Endorsement Advice and considered the comments received in response to EFRAG's Invitation to Comment on its Draft Endorsement Advice in its meeting on [January 2021](#).

Summary of respondents' views (comment letters to the IFRS IC)

- 13 The IASB have received six comment letters from European constituents (one of them from the UK) and seven from the accounting and auditing international associations and large audit firms.

¹ Case 1 - Waiver: The loan is repayable in five years and includes a covenant that requires a working capital ratio above 1.0 at each end of a quarter. The loan becomes repayable on demand if this ratio is not met at any of these testing dates. The entity's working capital ratio at 31 Dec 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. the entity expects the working capital ratio to be above 1.0 at 31 March 20X2 (and the other testing dates in 20X2).

Case 2: The fact pattern is the same as Example 1 except: the covenant requires a working capital ratio above 1.0 at each 31 March (ratio is tested only once a year at 31 March). 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 3: The fact pattern is the same as Example 1 except: 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 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.

² The IFRS IC considered that paragraph 72A of IAS 1 should apply for all those cases and 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'.

- 14 Only one of those respondents did not agree with the technical analysis that was the basis for the TAD. Few were referring to a potential issue with unclear/confusing guidance when reading BC48E. However, all respondents raised concerns with the outcome of the Amendments to IAS 1. They mentioned the technical analysis in the according to the Amendments seems classify loans with covenant conditions as current and non-current in a counterintuitive way. They mainly argued that the classification of liabilities might not reflect the intention if the counterparties and that it would be hard to understand for users that the classification of liabilities might change between periods. A few addressed that the due process was not appropriate as changes were made (mainly that paragraph 72A was added).
- 15 One European respondents and five respondents of the accounting and auditing international associations and large audit firms emphasised that this TAD could have a very significant impact in terms of changing the classification of liabilities with impacts on the going concern basis of financial statements.
- 16 Respondents views expressed on their comment letters are summarised below.
- Issues concerning the technical analysis done and potential application issues of the amendments*
- 17 One European respondent stated that he noted according to paragraph 72A, 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”. They 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, they 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.
- 18 Concerns in relation to consistent application of IAS 1 or sufficient guidance was raised from four of the large audit firms.
- 19 One respondent from this group stated that 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, they 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.

- 20 Three respondents (large audit firms) referred to unclear guidance in relation to BC48E. BC48E deals with conditions to an entity's cumulative financial performance for a period extending beyond the reporting period.
- 21 In this regard one large audit firm wrote that in the cases discussed by the IFRS IC these metrics are assumed to be calculated at a point in time. However, they 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, they 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, they do not consider the guidance to be clear for the following covenants:
- (a) covenants assessing financial performance over a cumulative period where the period is not coterminous with the end of the reporting period;
 - (b) 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
 - (c) 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.
- 22 One large audit firm stated that they 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.). They provided examples in the CL and reached different conclusions based on different reading of the requirement. They stated that 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.
- 23 One large respondent (large audit firm) stated that since the amendments apply to all financial liabilities, not only to loans with financial position covenants, they believe the clarification in the TAD is insufficient to achieve consistent application of the amendments. Additional application issues will arise from their point of view 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.
- 24 In addition one respondent remarks that it is 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.

Issues concerning the outcome of the amendment of IAS 1

- 25 All European respondents as well as the respondents from accounting and auditing international associations and large audit firms raised concerns with the outcome of the Amendments to IAS 1. They mentioned that the classification seems to be counterintuitive. A waiver to an existing breach would be sufficient, a waiver to a potential breach would be not. In either in case two³ and/or case three⁴ the technical analysis in the TAD seems not provide an intuitive basis for entities to determine how to classify loans with covenant conditions. They mainly argued that the classification of liabilities might not reflect the intention of the counterparties. They referred especially to seasonal business or start up business. Covenants agreed would be entity specific and reflect those circumstances. In such situations additional explanation of a potential breach of covenants that requires classification as current additional explanation would be necessary to users. In addition, it would be hard to understand for users that the classification of liabilities might change between periods.
- 26 Four European respondents and two respondents of the accounting and auditing international associations and large audit firms expressed concerns that the Amendments to IAS 1 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. This information will ultimately would not be meaningful for investors and other stakeholders as it will not be comparable.
- 27 One European respondent added that the outcome of applying the requirements in paragraph 72A came as a surprise for many stakeholders. Furthermore, they emphasised that there are valid questions about whether the requirements in paragraph 72A faithfully reflect contractual rights and obligations as those requirements ignore the ‘intended design of the covenants’ and thus, may result in information that is not relevant.
- 28 Furthermore, one European respondent and one respondent of the accounting and auditing international associations and large audit firms mentioned that they do not believe that debt classification based on a test at the end of the reporting period which does not concurred with the covenant defined test date aligns with the core principle of reporting the substance of the contract (loan agreement) in the financial statements. The Conceptual Framework chapter 4 paragraph 59 states that *“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”*. As a result, the classification outcome does not faithfully represent the contractual obligations of the borrower at the reporting date.
- 29 Another respondent of the accounting and auditing international associations and large audit firms also referenced to the Conceptual Framework chapter 1 paragraph 17 *“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*

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 a specified condition (a working capital ratio above 1.0 at 31 March 20X2).

The entity does not comply with the condition at the end of the reporting period because its working capital ratio is 0.9.

⁴ 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).

occur...” to illustrate an outcome that is at odds with the accruals basis of accounting.

- 30 One European respondent mentioned that, if the entity expects that the future covenant will be breached, appropriate disclosure would be needed. However, they believe that the TAD contradicts the terms of the contractual agreement and does not faithfully depict the arrangement and the economic situation.
- 31 Two respondents of the accounting and auditing international associations and large audit firms encourage the IASB 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 *Financial Instruments: Disclosures*)
- 32 However, one European respondent emphasised 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. This participant mentioned that it appears unclear whether and how the findings by the IFRS IC would apply were the customising service performed by a third party and suggested a clarification in this regard.

Issues concerning the due process of the amendment of IAS 1 and the TAD of the IFRS IC

- 33 Three European respondents and one respondent of the accounting and auditing international associations and large audit firms expressed its concerns with the due process in paragraph 72A⁵ of IAS 1, on which the IFRS IC has based its conclusion. It was added after the publication of the exposure draft (ED) in 2015 and was therefore excluded from the normal due process for exposure draft feedback. As the Amendments to IAS 1 will not be effective before 1 January 2023 it is preferable to undertake a standard-setting process.
- 34 One European respondents and three respondents of the accounting and auditing international associations and large audit firms added that the concerns should be better address by the IASB Board, rather than in IFRS IC and strongly suggest that further standard setting activity should be required.
- 35 Another respondent of the accounting and auditing international associations and large audit firms highlighted that the comment period for this TAD coincides with the peak financial reporting period for a significant proportion of preparers.
- 36 One European respondent and one respondent of the accounting and auditing international associations and large audit firms highlighted that as mentioned in paragraph 0 the effective date has been postponed, therefore, there is sufficient time to perform additional outreach to ensure the potential impact and effects are aligned with the IASB current expectation.

Question to EFRAG TEG

- 37 Does EFRAG TEG have any comments or questions regarding the summary of the respondents' views?

⁵ Paragraph 72A explains in further detail the principle in paragraph 69d which remained unchanged compared to the ED.

Appendix 1 – List of European respondents (One of them from the UK)

Name	Type of respondent	Country
Accounting Standards Committee of Germany (ASCG)	National Standard Setter	Germany
ACTEO – AFEP - MEDEF	Business Association	France
Autorité des Normes Comptables (ANC)	National Standard Setter	France
Business Europe	Business Association	Europe
Institute for the accountancy profession in Sweden (FAR)	Auditing Association	Sweden
The 100 Group	Business Association	UK

Appendix 2 – List of accounting and auditing international associations and firms

Name	Type of respondent	Country
Association of Chartered Certified Accountants (ACCA)	Accounting Association	International
Institute of Chartered Accountants in England and Wales (ICAEW)	Auditing Association	International
BDO	Auditing	International
Deloitte	Auditing	International
EY	Auditing	International
KPMG	Auditing	International
PricewaterhouseCoopers (PwC)	Auditing	International