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Berlin, 21 March 2022

Dear Andreas,

IASB Exposure Draft ED/2021/9 *Non-current Liabilities with Covenants*

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the Exposure Draft ED/2021/9 *Non-current Liabilities with Covenants (Proposed amendments to IAS 1)* issued by the IASB on 19 November 2021 (herein referred to as the 'ED'). We appreciate the opportunity to comment on the ED.

We welcome and support the IASB's proposal to clarify the classification of debt with covenants in response to the feedback received on the IFRS Interpretation Committee's tentative agenda decision published in December 2020. We believe that the IASB's proposal is a step in the right direction, as stakeholders had raised concerns about the outcomes and potential consequences of applying the 2020 amendments in some fact patterns discussed.

We generally agree with the IASB's proposal to require that conditions with which an entity must comply within twelve months after the reporting period have no effect on whether an entity has, at the end of the reporting period, a right to defer settlement of a liability for at least twelve months. Whilst we believe that, in general, the proposals provide a sufficiently clear dividing line of whether liabilities with covenants should be classified as current or non-current, we question, however, whether in some situations a classification as non-current warrants a fair presentation of an entity's financial position, for example, if an entity breaches a condition shortly after the reporting date.

We, therefore, agree with the IASB's view that the classification of a liability, alone, would not meet users' information needs in all circumstances. Rather, we also believe that disclosures are needed to provide users of financial statements with a complete picture, especially with regard to the risk that a liability classified as non-current could become repayable within twelve months after the reporting period.

We welcome that the IASB is proposing disclosures about conditions with which the entity must comply within twelve months after the reporting period. However, as it is likely that many of an entity's liabilities are subject to compliance with covenants, we are concerned that the proposed disclosure requirements would lead to lengthy descriptions of covenants in the notes, regardless of whether or not there is a risk that liability classified as non-current could become repayable within twelve months after the reporting period. We, therefore, recommend the IASB limit the scope of the disclosures to situations in which there is a substantial risk that the entity cannot comply with the conditions.

While we agree with the substance of most of the disclosure requirements proposed by the IASB, we do not agree with the proposal to require entities to disclose whether and how an entity expects to comply with the condition within twelve months after the reporting period (ref. paragraph 76ZA(iii)). We are concerned that if an entity discloses that it does not expect to comply with the conditions, such a statement will not be limited to a single liability due to cross-default clauses that are common in practice. Therefore, we believe that the proposed disclosure requirement is likely to result in boilerplate statements in the notes. Further, we note that – unlike other disclosure requirements in IFRS Standards – the proposed disclosure focuses on the entity's expectations or intentions, i.e., it includes a behavioural component. This puts a very strong focus on stewardship and may go beyond the purpose of financial statements. We also see challenges of auditing and enforcing a detailed statement of *how* the entity expects to comply with the conditions after the reporting period.

Further, we do not agree with the proposal to require entities to present separately, in their statement of financial position, liabilities that are subject to the entity complying with covenants. Although we understand the IASB intention to signal to users that classification as non-current is subject to the entity complying with specified conditions after the reporting date, we are concerned that almost all of an entity's non-current liabilities would be presented within that proposed new line item, thus limiting the informational value of this separate line item.

Our responses to the complete set of questions raised in the invitation to comment are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Ilka Canitz (canitz@drsc.de) or me.

Yours sincerely,

Sven Morich

Vice President

Appendix – Answers to the questions in the ED

Question 1 – Classification and disclosure (paragraphs 72B and 76ZA(b))
The Board proposes to require that, for the purposes of applying paragraph 69(d) of IAS 1, specified conditions with which an entity must comply within twelve months after the reporting period have no effect on whether an entity has, at the end of the reporting period, a right to defer settlement of a liability for at least twelve months after the reporting period. Such conditions would therefore have no effect on the classification of a liability as current or non-current. Instead, when an entity classifies a liability subject to such conditions as non-current, it would be required to disclose information in the notes that enables users of financial statements to assess the risk that the liability could become repayable within twelve months, including: (a) the conditions (including, for example, their nature and the date on which the entity must comply with them); (b) whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period; and (c) whether and how the entity expects to comply with the conditions after the end of the reporting period. Paragraphs BC15-BC17 and BC23-BC26 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

Classification (paragraph 72B)

We generally agree with the proposal that only conditions with which the entity must comply on or before the reporting period date should affect the classification of a liability as current or non-current. We believe that, in general, the proposed new paragraph 72B provides a sufficiently clear dividing line of whether liabilities with covenants should be classified as current or non-current.

Further, we note that the classification of long-term debt as current or non-current thereby reflects facts and circumstances that existed at the reporting date, hence not taking into account any events that occurred (or that might occur in the future) after the end of the reporting period. Therefore, we believe that the proposed new paragraph 72B is consistent with the principle of IAS 10, that financial statement amounts are not adjusted for events that are a result of conditions that arose after the reporting period date.

However, it is not entirely convincing to us that the classification of debt as current or non-current is unaffected by conditions with which an entity must comply within twelve months after the reporting period if it is foreseeable that the entity will not be able to meet those conditions.

In particular, we question whether financial statements fairly present an entity's financial position, if the entity classifies a liability as non-current, when it is clear that a breach of covenants will occur shortly after the end of the reporting period. In this context, it is not fully comprehensible that – if an entity has breached a condition – the outcome of such a covenants test that was performed based on the basis of facts and circumstances at a dater after the end of the reporting period but before financial statements are authorised for issue does not affect classification on the reporting date (e.g., a breach in a covenants test based on facts and circumstances as of 1 February, when the entity's reporting period ended on 31 December).

In this regard, we note that the classification principle in paragraph 69(d) of IAS 1 has some conceptual weaknesses that are the root cause of the difficulties encountered in classifying liabilities with covenants. While on the one hand, the classification depends on the entity having a right to defer settlement and that right must exist at the end of the reporting period; paragraph 69(d) of IAS 1 also includes a forward-looking component that states that the right to defer settlement must cover a period of at least twelve months after the reporting period. However, the ED does not solve this root cause of application issues that arise in connection with the classification of liabilities. We, therefore recommend the IASB reconsider the broader issue of classification in accordance with paragraph 69(d) of IAS 1 within its ongoing *Primary Financial Statements* project.

On balance, however, we agree with proposed new paragraph 72B, as it improves the classification requirements (when compared to the 2020 amendments) and the outcome of applying proposed new paragraph 72B on the classification of debt with covenants is more appropriate than under the 2020 amendments.

Disclosures about conditions – level of detail

We acknowledge that the IASB's classification proposals are linked to its proposals on presentation and disclosure (ref. paragraph BC17). We generally agree with the IASB's view that the classification of a liability, alone, would not meet the information needs of users of financial statements in all circumstances. Rather, we also believe that some disclosure requirements are needed to provide users of financial statements with a complete picture, especially with regard to the risk that a liability classified as non-current could become repayable within twelve months (ref. paragraph BC23). We therefore generally welcome that the IASB is proposing disclosures about conditions with which an entity must comply within twelve months after the reporting period.

Regarding the level of detail of the disclosures, we are concerned that the proposals would lead to extensive disclosures about conditions in the notes, as the proposed scope of the disclosure requirements under paragraph 76ZA(b) refers to all liabilities subject to conditions that are classified as non-current. Therefore, particularly with respect to the disclosures about conditions in proposed paragraph 76ZA(b)(i), entities might be prompted to disclose a long list of conditions that they must comply with within the next twelve months, regardless of whether or not there is a risk that a liability could become repayable. As the IASB itself explains in paragraph BC26 it is likely that many non-current liabilities are subject to the entity complying with conditions within twelve months after the reporting period, we are therefore concerned that relevant information might be obscured by a long list of conditions that the entity must comply with.

Although the IASB explains in paragraph BC26 that an entity would apply judgement in determining what information about conditions is material, and therefore – as we believe – would not necessarily need to disclose information about all conditions it must comply with, we believe that it may nevertheless be difficult for users of financial statements to clearly identify relevant information about conditions (from a potentially very long list of conditions). For example, users might face difficulties in differentiating between information about conditions that are rarely relevant, as these events occur infrequently (e.g., change of control-clauses) and conditions that may be critical given the entity's current financial position.

Further, we believe that applying materiality judgement as regards to what information about conditions is material, poses some practical challenges, as there are only two possible scenarios: either a loan agreement is subject to the entity's compliance with conditions, or it is not. Therefore, it may be difficult for entities to omit (immaterial) information about conditions in the notes.

We, therefore, recommend the IASB limit the scope of the disclosures to a subset of liabilities subject to conditions, i.e., we suggest the IASB clarify that an entity is only required to disclose information about conditions if there is a substantial risk that the liability classified as non-current could become repayable within twelve months after the reporting period (i.e., there is a high risk that the entity cannot comply with the conditions). We are well aware, that such an approach would involve application issues as to whether there is a substantial risk that the entity will not be able to comply with its covenants, and probably will trigger discussions with its auditors and regulators. However, in order to provide users of financial statements with useful information that is presented in a clear and concise manner in the notes, such an approach would have the advantage of focusing disclosures on information that is relevant to users of financial statements.

Disclosures about conditions –proposed items of information (paragraph 76ZA(b))

As explained above, we welcome that the IASB is proposing disclosures about conditions with which an entity must comply within twelve months after the reporting period, as we believe that such information is important for users of financial statements to understand whether there is a (substantial) risk that a liability – although classified as non-current – could become repayable within twelve months after the reporting period.

We agree with most of the proposed disclosure requirements. However, as explained in more detail above, we recommend the IASB restrict the scope of the disclosures to liabilities classified as non-current that have a high risk of becoming repayable within twelve months after the end of the reporting period.

Further, we do not agree with the proposed disclosures on '*whether and how the entity expects to comply with the conditions after the end of the reporting period*' (ref. paragraph 76ZA(iii)). While we believe that in some situations an entity might provide users of financial statements with useful information on *how* the entity expects to comply with the conditions (e.g., if the entity has renegotiated the conditions with the lender), we are however concerned that the disclosure requirement will predominantly result in generic explanations in the notes (i.e. boilerplate information).

Furthermore, we have considerable concerns about the requirement to disclose *whether* the entity expects to comply with the conditions. In particular, we are concerned that if an entity discloses that it does not expect to comply with the conditions, such a statement will not be limited to a single liability due to cross-default clauses that are common in practice, with the effect of casting significant doubts on its ability to continue as a going concern. Therefore, we believe that the proposed disclosure requirement is likely to result in boilerplate statements in the notes.

We note that – unlike other disclosure requirements in IFRS Standards – the proposed disclosure requirement in paragraph 76ZA(iii) focuses on the entity's expectations or intentions (rather than on judgement applied or assumptions made); i.e., it includes a behavioural component that is untypical for disclosure requirements in IFRS Standards. This puts a very strong focus on stewardship and may go beyond the purpose of financial statements. We also see challenges of auditing and enforcing a detailed statement of *how* the entity *expects* to comply with the conditions after the reporting period.

Suggestion for an additional disclosure

In addition to the disclosures proposed by the IASB, we suggest that significant amendments to covenant arrangements that occurred during the reporting period should be explained in the notes (e.g., information about a waiver obtained during the reporting period, or renegotiations of the conditions the entity must comply with). Such information would provide users of financial statements with useful information about whether any breaches or defaults of covenants occurred during the reporting period and would provide users of financial statements with relevant contextual information to assess which conditions may be critical to comply with in the future.

Question 2 – Presentation (paragraph 76ZA(a))
The Board proposes to require an entity to present separately, in its statement of financial position, liabilities classified as non-current for which the entity's right to defer settlement for at least twelve months after the reporting period is subject to compliance with specified conditions within twelve months after the reporting period. Paragraphs BC21-BC22 of the Basis for Conclusions explain the Board's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, do you agree with either alternative considered by the Board (see paragraph BC22)? Please explain what you suggest instead and why.

We do not agree with the proposal to require an entity to present separately, in its statement of financial position, liabilities classified as non-current for which the entity's right to defer settlement is subject to compliance with conditions within twelve months after the reporting period.

Whilst we understand the IASB's intention to signal that a liability classified as non-current is subject to the entity complying with specified conditions after the reporting period, we question whether users' information needs warrant the introduction of a separate line item in the statement of financial position.

Firstly, we observe that, in practice, many of an entity's debt instruments classified as non-current are subject to the entity complying with specified conditions (e.g., due to cross-default clauses that are usually agreed in loan arrangements). As a result, it is likely that almost all of an entity's long-term debt would be presented within the new line item, with the effect that the information value of such an additional line item in the statement of financial position is low.

Secondly, we believe introducing a new line item would unnecessarily increase the number of mandatory line items in the statement of financial position. Therefore, for an entity that is debt-financed only to a small extent, such a mandatory line item would lead to an unnecessary fragmentation of its long-term debt in the statement of financial position.

For the reasons above, we do not believe that introducing a separate line item in the statement of financial position is needed to provide users of financial statements with the information that there is a risk that the entity's non-current liabilities with covenants could become repayable within twelve months. Rather, we believe that requiring entities to disclose information about such conditions in the notes is sufficient to meet users' information needs.

Should the IASB adhere to its idea of using a separate line item in the statement of financial position to alert users of financial statements to seek additional information about conditions in the notes, we suggest the IASB to change the label of the minimum line item '*(non-current) financial liabilities*' (as required by paragraph 54(m) of IAS 1) into '*(non-current) financial liabilities (including financial liabilities with covenants)*'. Such a line item would include both, non-current liabilities with covenants and non-current liabilities without covenants and would also signal to users of financial statements that the entity's right to defer settlement could be subject to conditions, for which further explanations are included in the notes.

Question 3 – Other aspects of the proposals

The Board proposes to:

(a) clarify circumstances in which an entity does not have a right to defer settlement of a liability for at least twelve months after the reporting period for the purposes of applying paragraph 69(d) of IAS 1 (paragraph 72C);

(b) require an entity to apply the amendments retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, with earlier application permitted (paragraph 139V); and

(c) defer the effective date of the amendments to IAS 1, *Classification of Liabilities as Current or Non-current*, to annual reporting periods beginning on or after a date to be decided after exposure, but no earlier than 1 January 2024 (paragraph 139U).

Paragraphs BC18-BC20 and BC30-BC32 of the Basis for Conclusions explain the Board's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

Circumstances in which an entity does not have a right to defer settlement (paragraph 72C)

We do not agree with the proposal, as we believe that the proposed wording in paragraph 72C(b) as regards to whether an uncertain future event or outcome occurs (or does not occur), and its occurrence (or non-occurrence) is '*unaffected by the entity's future actions'* is not clear and therefore may lead to diversity in practice. Furthermore, we believe that applying paragraph 72C(b) to a liability that is a financial guarantee or a insurance contract liability does not result in a faithful representation of an entity's financial position.

While we understand the IASB's intention to clarify which conditions are within the scope of paragraph 72B, and which are not, we are aware of some conditions, for which the proposed paragraph 72C(b) could lead to unintended consequences. For example, a change of control or a credit rating downgrade are events beyond the control of the entity. In such cases, the proposed paragraph 72C(b) would lead in all debt with covenants (related to a change of control of a rating downgrade) being classified as current, as the occurrence or non-occurrence of these events are unaffected by the entity's actions. However, in our opinion, a classification as current would not be an appropriate presentation as long as the change of control or credit rating downgrade have not yet occurred at the end of the reporting period. Therefore, we recommend the IASB either clarify the wording in proposed paragraph 72C(b) or delete paragraph 72C(b) in its entirety. Further, we suggest the IASB transfer paragraph BC20 to the main body of IAS 1, as it contains some helpful explanation of how paragraph 72C(b) is intended to work.

Furthermore, we note that the proposed new paragraph 72C(b) enumerates liabilities that are financial guarantees and insurance contract liabilities as an example of liabilities that could become repayable within twelve months after the reporting period if an uncertain future event or outcome occurs and its occurrence (or non-occurrence) is unaffected by the entity's future actions. Consequently, applying the proposal would result in these liabilities always being classified as current. However, we believe that the outcome of such a classification does not faithfully reflect an entity's financial position, as it reflects a '*worst-case scenario*' rather than to present the existing rights and obligations as they exist at the reporting date. By contrast, paragraph 132(b) of IFRS 17 *Insurance Contracts* adopts a more appropriate approach to maturity analysis disclosures for portfolios of (re)insurance contracts based on the estimated timing of future cash flows. Therefore, as already explained above, we recommend the IASB either clarify the wording in proposed paragraph 72C(b) or delete it.

Interaction of the proposals with the disclosure requirements of IFRS 7

We note that the relationship between the requirements of IAS 1 on the classification of long-term debt with covenants and the disclosure requirements of IFRS 7 remains unclear in several respects:

On the one hand, we note that the disclosure requirement of paragraphs 39(a) and (b) of IFRS 7 that requires an entity to disclose a maturity analysis for financial liabilities follows a different concept with regard to the maturity date than the requirements of IAS 1 on classifying debt as current or non-current. As the IASB explains in B11C and BC57 of IFRS 7, that maturity analysis shows the remaining contractual maturities, based on the earliest contractual maturity date, as such disclosure reflects the entity's risk of repaying its liabilities earlier than expected.

On the other hand, the disclosure requirements of IAS 1 also overlap with the disclosure requirements of IFRS 7. For example, paragraph 18(c) of IFRS 7 requires disclosure on whether any defaults were remedied, or whether the terms of loans payable were renegotiated after the end of the reporting period (but before the financial statements are authorised for issue). Similar disclosures are also required according to paragraph 76 of IAS 1 (i.e., paragraph 76(b) of IAS 1 also requires disclosures on the rectification of a breach of a long-term loan arrangement classified as current, if that rectification occurred between the end of the reporting period and the date the financial statements are authorised for issue).