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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.

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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

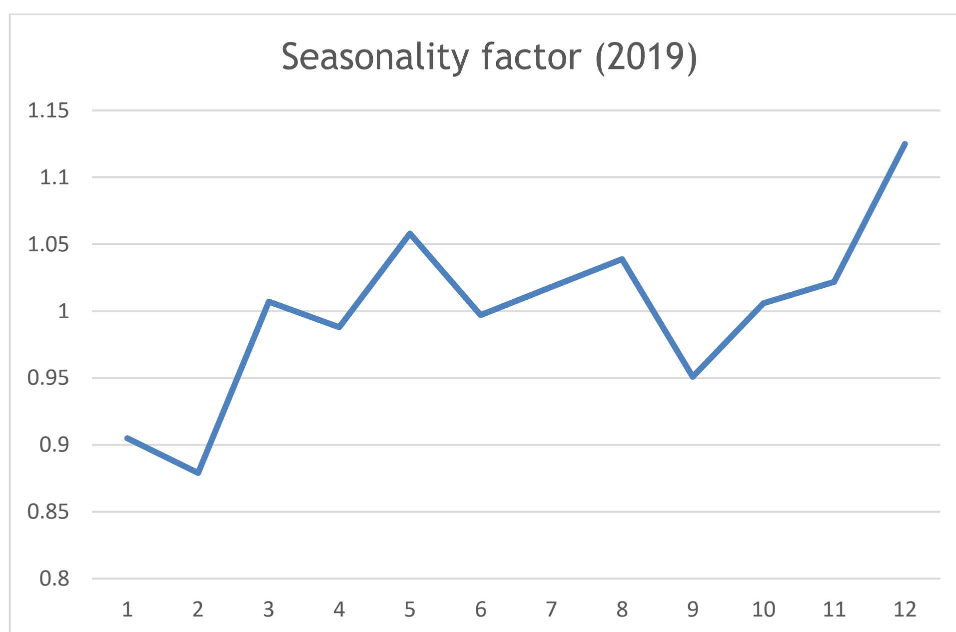
*The ratio used to assess compliance with IAS 1.72A is the highest future ratio in the next 12 months, as the entity must comply with this higher ratio within the next 12 months in order to have the right to defer payment for the next 12 months, as demonstrated in case 3 of the tentative agenda decision.

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