Tel: +44 20 7893 3300
Fax: +44 20 7487 3686
@: abuchanan@bdoifra.com
www.bdointernational.com

BDO IFR Advisory Limited
Contact: Andrew Buchanan
55 Baker Street
London W1U 7EU
United Kingdom

International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

21 March 2022

Dear Sir

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

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We support the efforts of the IASB to improve the requirements applicable to the classification of liabilities as current or non-current. We particularly support the proposed requirements which would result in a liability not being classified as current due to 'notional' covenant tests based on conditions that will be tested based on financial positions and results in the future.

However, we have concerns about some aspects of the proposals, including some of the proposed disclosures, as well as the requirement to present liabilities subject to conditions separately in the statement of financial position.

Additionally, we are concerned that some of the proposals may have unintended consequences, which might result in many financial liabilities being classified as current at all times due to there being clauses which may result in them becoming repayable within the next 12 months due to the occurrence or non-occurrence of events that are unaffected by an entity's actions. The reasons for our concerns are explained in Appendix A using illustrative examples.

Our responses to the questions in the ED are set out in the attached Appendix.

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.

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Yours faithfully

Andrew Buchanan.

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

Appendix

Question 1

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.

We agree with the Board's proposal to replace the majority of the requirements in IAS 1.72A with new requirements in IAS 1.72B. We agree that specified conditions with which an entity must comply within twelve months after the reporting period should not have an effect on whether a liability is classified as current or non-current. The reasons for our view are set out in our response to the IFRS Interpretations Committee agenda decision *Classification of Covenants as Current or Non-Current.*

We agree with the proposed disclosures in IAS 1.76ZA(b)(i)-(ii), however, we do not agree with the proposed disclosure in IAS 1.76ZA(b)(iii).

We believe that the disclosures in (i) and (ii) would provide users of financial statements useful information about conditions that may result in liabilities becoming repayable within 12 months. We also believe that these disclosures are capable of being audited as they are based on known conditions and financial positions.

We do not believe that (iii) would provide users of financial statements with useful information because the information is forward-looking and speculative in nature. We agree with the alternative view of Mr. Mackenzie and Mr. Scott in AV5, particularly (**emphasis added**):

> *They disagree because, in their view, entities should not be required to provide forward-looking information with respect to future compliance with covenants. For example, in the case of a current ratio, providing this information implicitly involves forecasting the balances in the numerator and denominator.* ***Further, users of***

<u>financial statements should be capable of assessing the risk that a condition may be breached based on the proposed identification of these non-current liabilities and the other proposed disclosures supported by an analysis of the current and past financial reports along with additional economic information.</u> The disclosure requirement proposed in paragraph 76ZA(b)(iii) might prompt entities to provide a high volume of information or produce boilerplate disclosures.

For these reasons, we do not believe that it is necessary for IFRS Accounting Standards to introduce requirements for an entity to disclose its expectations of future events and performance.

Additionally, we believe that this type of disclosure would be difficult to audit, as it would require an examination of every assumption an entity makes about its expected performance over the next 12 months. We also believe that requiring forward-looking information in the financial statements may conflict with regulatory requirements in many jurisdictions, which limit the extent to which entities may make statements about their expectations of future events.

Question 2

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 Board's proposal to separately present all liabilities for which the entity's right to defer settlement for at least twelve months is subject to compliance with specified conditions. The reasons for our disagreement are:

(a) The majority of these types of liabilities are bank loans or other similar financial liabilities, of which substantially all are subject to some type of condition. In our experience, it is unusual in the current global lending environment for a lender to grant a loan to a borrower where there are no conditions that if violated, may result in accelerated repayment. Because of this, we believe a majority (perhaps a substantial majority) of such bank loans would be presented separately in accordance with this proposed requirement, which in our view, defeats the purpose of the requirement.

(b) The reasons noted in AV3 and AV4 of the Alternative View presented in the basis for conclusions to the exposure draft. In our view, disclosure of the conditions and whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period (IAS 1.76ZA(b)(i)-(ii) of the exposure draft) are sufficient in order to provide users of financial statements with information about conditions associated with liabilities, which may result in them becoming repayable within the next twelve months. We also agree with the alternative view that this requirement is extremely rules-based, which contradicts the principles-based nature IFRS Accounting Standards.

Question 3

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.

We are supportive of the Board's efforts to clarify the requirements of IAS 1.72B in the proposals by also introducing IAS 1.72C. We agree with IAS 1.72C(a) because it clarifies that loans which are presently due on demand regardless of an entity's compliance with conditions are always classified as current liabilities. We do not agree with IAS 1.72C(b) because we believe that it introduces the potential for unintended consequences, which may result in a very large number of bank loans being classified as current.

We understand from BC18(b) and BC20 that the Board's intention with introducing IAS 1.72C(b) was to clarify that situations where an entity cannot affect the occurrence or non-occurrence of future events are not 'liabilities for which an entity's right to defer settlement is subject to compliance with conditions', meaning that the principle introduced by IAS 1.72B does not apply to such situations.

We agree that in some cases, this outcome is appropriate. For example, as noted in IAS 1.72B, the payment of claims under an insurance contract is unaffected by the entity's actions because those actions do not affect whether an insured event occurs or not. Therefore, for an insurance company that presents a classified statement of financial position, such liabilities would be presented as current.

However, we believe that the application of IAS 1.72B(b) to other fact patterns may result in inappropriate outcomes. To illustrate our concern, consider the following example, which incorporates recent events, but is not limited to those circumstances.

Example

Entity A has significant operations in Russia. Entity A is preparing its financial statements as at 31 December 2021. Entity A has a bank loan with the following contractual terms:

- The loan is normally repayable on 31 December 2025, unless either of the following clauses are triggered, which result in the loan becoming due on demand immediately.
- Covenant violation: Entity A must meet a quarterly working capital ratio of 1:1.
- Material adverse event: the loan becomes due on demand if a material adverse event occurs, which is any event that significantly reduces the value of the company, including, but not limited to, a loss of major customers, major lawsuits, adverse regulatory rulings, etc.

Entity A complies with its covenant test as at 31 December 2021, however, it does not expect to comply with the material adverse event contractual term in any of its subsequent quarters over the next twelve months due to the effects of the Ukraine-Russia conflict and the consequential effects on the Russian economy. Applying IAS 1.72B(b), considering only the covenant violation clauses, Entity A would classify the loan as a non-current liability because the future conditions (i.e. the quarterly covenant tests) do not affect whether the right to defer settlement for at least twelve months exists as at 31 December 2021.

However, Entity A would be required to classify the loan as a current liability as at 31 December 2021 (and all period ends) because of IAS 1.72C(b). This is because of the material adverse event clause, which may result in the loan becoming repayable within twelve months after the reporting period due to a future event or outcome that is unaffected by the entity's future actions. This could include any event that might trigger a 'material adverse event' (e.g. a global pandemic, armed conflict, market forces, financial crises, etc.).

As illustrated above, applying IAS 1.72B(b) in isolation would not result in the loan being classified as current, but because of IAS 1.72C(b), the loan must be classified as current because it may become repayable within twelve months due to future events or outcomes that the entity cannot affect.

We do not believe that this outcome provides useful information to users of financial statements for similar reasons to those we raised in our response to the IFRS Interpretations Committee agenda decision *Classification of Covenants as Current or Non-Current*. We believe the disclosure of such conditions is appropriate, however, a condition that may potentially require repayment at any time resulting in current classification for all such instruments would not represent the fact that in our view, these clauses are typically seen as protective in a manner similar to covenants. For example, a bank being able to demand repayment of a loan when a covenant is violated provides protection to the bank in the event that the financial position of the borrower deteriorates. This is also the case for a material adverse event clause, but based on our interpretation of IAS 1.72C(b), such a clause would not be within the scope of IAS 1.72B(b) because the occurrence of an event triggering a material adverse event clause may be unaffected by the entity's actions.

Similar concerns to the point above also apply to other events that may be unaffected by the entity's actions, which could trigger repayment of a loan. For example, certain change of control provisions. In some cases, an entity via its board of directors or other governing body may be able to avoid a change of control, but this may not always be the case (e.g. a hostile takeover). Applying IAS 1.72C(b), if such a hostile takeover were possible, and it would trigger the repayment of a bank loan, then the bank loan would always be presented as a current liability, which we do not believe is a satisfactory outcome.

It is challenging to propose amendments that address the concerns raised above without causing unintended consequences. Our proposed amendment to IAS 1.72C(b) aims to limit the concerns raised above:

Proposed amendment to IAS 1.72C(b) (edit in **bolded underlined text**) An entity does not have the right to defer settlement of a liability for at least twelve months (as described in paragraph 69(d)) if the liability could become repayable within twelve months after the reporting period: (a) at the discretion of the counterparty or a third party—for example, when a loan is callable by the lender at any time without cause; or (b) if 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—for example, when the liability is a financial guarantee or insurance contract liability. In such situations, the right to defer settlement is not subject to a condition with which the entity must comply as described in paragraph 72B. **Future events or outcomes whose occurrence (or non-occurrence) is unaffected by the entity's future actions are disregarded if their likelihood of occurrence in the next twelve months is considered to be remote as at the reporting date.**

We believe that 'remote' is an appropriate threshold for determining whether such events should affect the classification of a liability because the weighting of evidence must be significantly in favour of the event not occurring for the future event or outcome to be disregarded. 'Remote' is already a term used in other IFRS Accounting Standards (IAS 36.24(c), IAS 36.99(c), IAS 36.28, etc.), and while this outcome does require judgement to be applied is classifying a liability as current or non-current, we believe that 'remote' is a sufficiently high hurdle to prevent abuse.

If the Board were to incorporate the edits we have proposed above, we also believe that any contractual terms that may result in a financial liability becoming repayable in the next twelve months, but the likelihood of which is remote, should be disclosed along with the fact that the entity considers the likelihood to be remote. For example, in the case of a material adverse event clause, the existence of such a clause would be disclosed and why the entity considers the likelihood of it being triggered in the next twelve months is remote.

We agree with the Board's proposed approach to apply the amendments retrospectively, as well as the deferral of the effective date for the suite of amendments to be no earlier than 1 January 2024.