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International Accounting Standards Board
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21 March 2022

Dear Board members,

Invitation to comment – IFRS Standards Exposure Draft ED/2021/9 – *Non-current Liabilities with Covenants*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the International Accounting Standards Board's (IASB or the Board) Exposure Draft ED/2021/9 – Non-current Liabilities with Covenants (the ED).

We support the Board's effort to address the concerns about the outcomes of the 2020 amendments, to avoid unintended consequences and inconsistent practices.

Specifically, we support the Board's proposal to base classification on the conditions that an entity is required to comply with at the end of the reporting period, rather than within 12 months of that date, as we believe it provides more useful information to users.

We also support the proposed deferral of the effective date for the 2020 amendments to align with the effective date of the proposed amendments.

However, we have the following concerns:

1. We do not support the proposal to introduce an entity's ability to impact the occurrence or non-occurrence of uncertain future events or outcomes as a determinative factor when assessing whether a liability should be classified as current or non-current, since the underlying concept or principle aligning a "right" with the notion of "unaffected" is unclear. Furthermore, the notion of "unaffected" is not defined, and it would be difficult to define, therefore, it will be challenging to apply in practice. We believe a more consistent approach, both conceptually and practically, would be to remove paragraph 72C(b). This would allow for the assessment of whether a right exists at the end of the reporting period, based on the conditions at the reporting date, regardless of an entity's ability to affect the occurrence or non-occurrence of that uncertain future event or outcome.

2. We do not think that requiring separate presentation of liabilities subject to conditions is justifiable, as we believe the need for separate presentation should be a matter of judgement based on materiality.

3. The proposal would require entities to assess their anticipated future compliance with covenants that will only be tested at a later date. We suggest the Board considers providing additional guidance on the type of evidence on which an entity should base such disclosures.

4. It is not clear from the proposals whether it was the Board's intention that the requirements regarding classification as current or non-current, and the related presentation and disclosure requirements, should apply to financial liabilities only, or to all types of liabilities. We believe the scope of the proposed requirements should be limited to financial liabilities.

Our detailed responses to the questions are set out in the Appendix to this letter.

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

Ernst & Young Global Limited

Appendix - Responses to specific questions

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

We support the overall direction of the proposal and believe that classification based on the conditions an entity is required to comply with at the end of the reporting period, rather than within 12 months from that date, provides more useful information to users.

However, we see some inconsistency between paragraphs 72B(b) and 72C(b). The proposed wording in paragraph 72C(b) could result in diversity in practice as the notion of "unaffected by the entity's future actions" is not clear and there are numerous conditions (covenants) that could be argued to be both affected and unaffected by the entity's future actions depending on the point of view taken. Therefore, conclusions could differ on whether a particular condition is within the scope of paragraph 72B(b) or paragraph 72C(b).
For example:

1. It is not uncommon that loans are repayable immediately on a change of control. Since a change in control clause could be triggered by the actions of a certain shareholder/group of shareholders (an uncertain event "unaffected by the entity's future actions"), the proposal could result in any liability with such a clause being classified as current. Alternatively, considering that shareholders are related parties of the entity, some may argue that the entity is in a position to affect the occurrence of

change in control and, therefore, classification of such a liability as non-current is appropriate.

2. An entity's deferral of settlement may be conditional on renewing its licence to operate in the 12-month period following the end of the reporting period. In that case, the entity would be in a position to affect deferral of settlement by filing an application for renewal, but whether the application will be approved by the relevant authority is outside the control of the entity. The issue, in this case, is whether the entity's ability to affect deferral is sufficient under paragraph 72C(b).
3. In some cases, deferral of settlement is conditional on audited financial statements by a specific date after the end of the reporting period. The entity may be able to affect whether it obtains an audit opinion by the said date, but whether the entity's ability to influence is sufficient to meet the threshold in paragraph 72C(b) is unclear.

Furthermore, other non-financial covenants, which are common, may in many cases, result in current classification in instances where such classification appears counterintuitive. For example, an extreme weather event or a war could cause a material adverse change triggering early repayment. Similarly, there are likely many objective material adverse change clauses that could be triggered by events that the entity cannot affect and which would, therefore, result in the related loans always being classified as current. Many debt arrangements are likely to include these types of clauses and entities currently assess these based on the circumstances at the reporting date. Therefore, the proposal in paragraph 72C(b) could result in a significant change in practice with many liabilities being reclassified to current compared to current practice. Whether that is the Board's intention, is not clear to us.

The wording "unaffected by the entity's future actions" is ambiguous, as illustrated in the three examples above, especially considering that paragraph BC20 clarifies that it is only about being able to "affect", not control, the occurrence of the event. It is unclear how direct and how significant the ability to influence/affect the occurrence of the uncertain future event must be in order for the condition to be outside the scope of paragraph 72C(b). Given the lack of guidance on how significant the ability to affect must be in order to fall within the scope of paragraph 72C(b), we are concerned that consistency in practice will not be achieved, and that the proposed amendments will be challenging to apply in practice.

The wording "unaffected by the entity's future actions" also raises the question of whether uncertain future events that are under the control of the entity's individual shareholders but not the entity itself, such as in the change of control clause example above, should be considered as "unaffected by the entity's future actions" as the entity cannot control its shareholders or whether the entity should be seen as an extension of its shareholders or visa versa.

On the other hand, we find the clarification in paragraph BC20, which makes it clear that "unaffected by the entity's future actions" is not the same as "within the entity's control", useful in other circumstances. There are a number of things which are frequently the subject

of covenants, e.g., revenues and profit, which are not in the entity's control but are affected by its actions.

We believe the concerns raised above are twofold:

a) The underlying concept or principle aligning a "right" in paragraph 69(d) with the notion of "unaffected" in paragraph 72C(b) is unclear, and
b) The notion of "unaffected" is not defined and, as such, will be challenging to apply in practice in many cases.

Therefore, if the Board believes that introducing such a notion for the purpose of distinguishing between current and non-current liabilities is helpful, we encourage the Board to clarify why the entity's ability to affect the occurrence or non-occurrence of an uncertain future event or outcome should impact classification. Furthermore, in that case, the Board should provide additional guidance to clarify how to assess the notion of "unaffected" in practice.

We believe a more consistent approach, both conceptually and practically, would be to remove paragraph 72C(b). This would allow for assessment of whether a right exist at the end of the reporting period, based on the conditions at the reporting date, regardless of an entity's ability to affect the occurrence or non-occurrence of that uncertain future event or outcome. This would be consistent with the guidance in IAS 10 *Events after the Reporting Period*, which stipulates that the amounts in the financial statements are not adjusted for conditions that arose after the reporting date.

Furthermore, in practice, entities commonly negotiate a modification of loan agreements, prior to the end of the reporting period, that eliminates a covenant requirement at the reporting date (sometimes referred to as a "suspension" or "disapplication" of the year-end covenant test) or amends the requirement. Allowing the entity to comply with the covenant requirement, when absent such a modification, the entity would have been in violation at the end of the reporting period. However, compliance with the same covenant will be tested within the next 12 months, in, say, 3 or 6 months. Current practice is mixed in these situations, in that some consider that such reliefs effectively imply a grace period until the next agreed measurement date, and, thus, reclassify otherwise non-current liabilities to current if the next agreed measurement date is in less than 12 months. Others considers such reliefs "permanent", in that the next measurement date was already agreed before the relief was obtained, and, thus, the non-current liabilities remain non-current as they would have in any other situation in which there was no covenant breach as of the reporting date. We believe the Board should clarify what the appropriate classification under the amended standard should be in these circumstances, considering that these circumstances are quite common in practice.

Disclosures

In general, we support the proposed disclosures. We believe the proposal fills an existing gap for such disclosure, since current standards (IAS 1 *Presentation of Financial Statements* and

IFRS 7 *Financial Instruments - Disclosures*) only explicitly require disclosures related to covenants in specific circumstances (e.g., a breach or remedied breach at the reporting date). The proposed disclosure requirements could drive more consistency in disclosure of covenants.

We believe that the qualitative disclosure of expected compliance with conditions within 12 months from the reporting period, i.e., paragraph 76ZA(b)(iii), is useful information to users and could also inspire management to act sooner on those expectations, for example, by initiating waiver discussions with the relevant financial institution.

However, the expected compliance disclosure requirement conflicts to some extent with the Board's intention to remove the complexity introduced by the current requirement in paragraph 72A, as highlighted by the Board in paragraph BC16(b), since the proposed disclosure in paragraph 76ZA(b)(iii) would still require the entity to assess its anticipated future compliance with a covenant (which could include a non-financial or performance condition) that will only be tested at a later date. This will often involve predicting future performance and will in some instances also involve predicting the occurrence or non-occurrence of events that may not be within the control of the entity, typically in the case of non-financial covenants. We therefore suggest that the Board considers providing additional guidance on the type of evidence an entity should base such disclosure on. Furthermore, in this context, rewording paragraph 76ZA(b)(iii) may be helpful. It is unclear what is meant by "whether and how" an entity expects to comply with conditions in the future. We believe that the wording "whether and on what basis" may clarify the type of information that might be relevant to disclose.

Paragraph 76ZA(b)(ii) requires disclosure of whether an entity would have complied with future conditions based on its circumstances at the reporting date. It would be helpful if the Board clarified that this requirement is about comparing the future date condition against the reporting date performance and financial position, i.e., merely a mechanical exercise, as some may read the proposal to require predicting the entity's performance and financial position at the relevant future date. In the latter case, the requirements in paragraphs 76ZA(b)(ii) and 76ZA(b)(iii) would overlap, which we do not believe to be the Board's intention. Furthermore, in that case, the concerns raised in the context of performance conditions remain in that the implications of covenants that were agreed on reflecting a seasonal business or a start-up entity, for instance, are unclear.

Given the additional disclosure requirements proposed relating to covenants, we believe the Board should reassess the guidance in paragraphs 81-83 of Practice Statement 2 – *Making Materiality Judgments* to determine if this is still consistent with the proposed guidance. For example, we would expect that the guidance in paragraph 83 (i.e., indicating that information about a covenant is not material, when there is only a remote likelihood of the covenant being breached) also applies to the disclosures required by the proposed paragraph 76ZA(b), but we acknowledge that others might be of a different view.

It would be useful to clarify the interaction between the proposed disclosure requirements and the liquidity risk disclosures in IFRS 7. For example, requiring the proposed disclosures to be included in the same note as the liquidity risk disclosures would avoid related information being scattered across the financial statements.

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.

Similar to the alternative view expressed by Mr Mackenzie and Mr Scott, we do not believe separate presentation should be introduced as a mandatory minimum requirement. While we agree that separate presentation in the statement of financial position would draw users' attention to those liabilities which are subject to the conditionality (as noted in paragraph BC21(b)), we believe the need for separate presentation should rather be left to judgement based on materiality. While we acknowledge the arguments provided in paragraph BC21 to support separate presentation, we believe the additional disclosures proposed would be sufficient in many cases. Given the prevalence of covenants in practice, the proportion of liabilities subject to the separate presentation is expected to be significant, and likely greater than those liabilities that are not subject to it. Therefore, the separate presentation could potentially prove to have limited impact as most non-current liabilities are subject to conditions.

If the Board decides to continue with the proposed separate presentation requirement despite the concerns raised, we believe it would necessitate an amendment to paragraph 54 of IAS 1 to include those liabilities classified as non-current, but subject to terms and conditions that could cause them to be payable within one year, as a required line item.

Since IAS 1 applies to all liabilities, it is not clear from the proposals whether it was the Board's intention that the requirements regarding classification as current or non-current, and the related separate presentation, should only apply to financial debt (e.g., Bank borrowing). Based on the current drafting, the requirements would also apply to liabilities within the scope of other standards (e.g., IFRS 2 *Share-based Payment*, IFRS 15 *Revenue from Contracts with Customers*, IFRS 16 *Leases*, IFRS 17 *Insurance Contracts*, IAS 12 *Income Taxes*, IAS 19 *Employee Benefits*, IAS 26 *Accounting and Reporting by Retirement Benefit Plans*, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) if they are subject to covenants/conditions.

If the requirements also apply to these other liabilities, multiple lines in the statement of financial position could be impacted by the separate presentation requirements. If this is the Board's intention, the standard should be clear on whether this would require:

1. Each affected line item to be split between those subject to conditions in the next 12 months and those that are not.
   Or
2. One aggregate line item in the statement of financial position for all those liabilities, regardless of nature, that are subject to conditions within 12 months after the end of the reporting period.

We believe that the requirements should only apply to financial liabilities (e.g., bank borrowings). If the Board agrees, we suggest it considers whether the requirements would be better placed in IFRS 7 as, in that case, the scope of the proposed requirements would be aligned with the scope of the standard prescribing them. Regardless of the Board's intended scope, the amendments should be clear on the scope to avoid diversity in practice.

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.

We support the proposed retrospective application as classifying a liability on a different basis in the comparative period(s) is unlikely to provide useful information. We also support the proposed deferral of the 2020 amendments to align with the effective date of the proposed amendments since this avoids unnecessary effort by preparers.