

Paris, 11 January 2021

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PDC n°1

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EFRAG Draft Endorsement Advice on the IASB's Amendments to IAS 1—*Classification of Liabilities as Current or Non-current and Deferral of Effective Date*

Dear Jean-Paul,

I am writing to you on behalf of Autorité des Normes Comptables (ANC) in connection with the above-mentioned Draft Endorsement Advice (DEA).

ANC observes that EFRAG has tentatively concluded in its DEA that the amendments to IAS 1 *Presentation of Financial Statements* (amendments) (i) meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards as set out in Regulation (EC) No 1606/2002 and (ii) are likely to be conducive to the European public good.

ANC thinks that the technical analysis supporting those conclusions should be investigated further. A recent development has indeed provided additional insights into how the amendments would apply in particular circumstances. ANC thinks this is new information that should warrant EFRAG's careful consideration.

[Agenda Paper 2](#) for the December 2020 IFRS Interpretations Committee (Committee) meeting explains that (i) the IASB staff has been made aware of differing views about how an entity applies the amendments to three fact patterns and (ii) divergence in practice may develop as a result thereof¹. Accordingly, the IASB staff decided to bring this matter to the Committee. Specifically, the Committee discussed how an entity, applying paragraph 69(d) of the amendments², determines whether it has the right to defer settlement of a liability for at least twelve months after the reporting period when (i) the right to defer settlement is subject to the entity complying with specified conditions (such as covenants), and (ii) compliance with those specified conditions is tested at a date after the end of the reporting period. By doing so, an entity determines whether it classifies a liability as current or non-current in its statement of financial position. The Committee published a [Tentative Agenda Decision](#) (TAD) concluding that the entity has no such right in the three fact patterns. The Committee's TAD is open for comments until 15 February 2021.

¹ ANC observes that several comments letters on the Exposure Draft ED/2020/3 *Classification of liabilities as current or non-current—Deferral of effective date* published in May 2020 had already raised concerns about the differing views about how an entity would apply the amendments to fact patterns similar, or identical to, those discussed by the Committee in December 2020. This is explained in paragraphs 16–19 of [Agenda Paper 29A](#) for the June 2020 IASB meeting. Paragraphs 18 and 19 of this Agenda Paper explain that '...as stated in paragraph BC5 of the Exposure Draft, the [IASB] did not propose any changes to the amendments issued in January 2020 other than the deferral of the effective date. Therefore, considering implementation questions would go beyond the scope of the proposal in the Exposure Draft and could delay the operational relief that the proposed deferral is intended to provide. Consequently, [the staff] do not propose to address these implementation questions as part of this project. However, [the staff] will consider whether further clarification of the Amendments to IAS 1 is required'.

² Paragraph 69(d) states : 'An entity shall classify a liability as current when: [...] it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.'

Two fact patterns (cases 2 and 3 in the TAD) have drawn stakeholders' attention. In both cases, an entity has a loan that includes covenants and the loan becomes repayable on demand if the covenants (working capital ratios in the TAD) are not met at any testing date. The entity determines whether it classifies the loan as current or non-current in its statement of financial position at the reporting date. In particular:

- in case 2, the loan includes only one covenant that the entity tests three months after the reporting date—in other words, the entity's right to defer settlement of the loan for at least twelve months after the reporting date is subject to the entity complying with a specified condition three months after that date; and
- in case 3, the loan has two covenants: one that the entity tests at the reporting date, the second one is tested six months after that date—in other words, the entity's right to defer settlement of the loan for at least twelve months after the reporting date is subject to the entity complying with two specified conditions, one at the reporting date, the other one six months after the reporting date.

On the basis of the working capital ratio existing *at the reporting date* and irrespective of the entity's expectation with regard to the working capital ratio that will exist at a later date, the entity observes that:

- in case 2, it would not meet the covenant that is due to be tested three months after the reporting date; and
- in case 3, it meets the covenant that is tested at the reporting date but would not meet the covenant that is due to be tested after the reporting date.

Paragraph 72A of the amendments³ states (emphasis added): '*an entity's right to defer settlement of a liability for at least twelve months after the reporting period must have substance and, as illustrated in paragraphs 73–75, must exist at the end of the reporting period. 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*'. Accordingly, the Committee tentatively concluded that the entity has no right to defer settlement of the loan for at least twelve months after the reporting period in the two aforementioned cases—the entity classifies the loan as current at the reporting date.

ANC received feedback that the Committee's tentative conclusion may faithfully reflect the requirements in the amendments. However, ANC has been made aware that this conclusion came as a real surprise for a number of stakeholders who had not anticipated the accounting implications of applying the amendments to the two above-mentioned fact patterns. ANC understands that the fact patterns are rather common and that entities are currently applying the existing requirements in IAS 1 differently when assessing the effects of covenants on the classification of their liabilities—there is diversity in reporting practices. Many entities only assess, at the reporting date, whether they comply with the conditions that have to be tested at the reporting date. Some other entities also assess whether they *expect* to comply with the conditions that are due to be tested at a later date—however those entities do not assess whether they meet those conditions from the reporting date onwards. Accordingly, ANC expects the amendments to result in a significant accounting change for many entities. The effects of such a change are far-reaching in nature because the classification of liabilities as current or non-current usually affects the assessment of an entity's liquidity and thus, (i) its ability to access debt and (ii) the cost of its debt.

ANC has not identified in EFRAG's DEA any specific development about how entities would apply paragraphs 69(d) and 72A of the amendments in circumstances identical, or similar to, those described in the TAD and is thus unclear about whether EFRAG anticipated, during its deliberations, all the changes that may arise from those paragraphs. Accordingly, ANC recommends EFRAG consider how the Committee's tentative analysis could affect its assessment of the amendments.

Additionally, ANC has tentatively received feedback from a number of stakeholders questioning whether the amendments would result in useful information when applied to the two above-mentioned fact patterns.

Those stakeholders say that requiring an entity to assess at the reporting date whether it complies with the conditions that are due to be tested at a subsequent date, *solely on the basis of data observed at the reporting date*, disregards the contractual terms specified in the loan arrangement.

Those stakeholders also say this requirement may result in information that is not faithful for entities that have a seasonal or cyclical business or are subject to specific circumstances (such as an entity that is in its start-up phase). Those entities usually negotiate loans whose covenants are adjusted to reflect such a seasonality or cyclicity or specific circumstances. For example, in cases 2 and 3 of the TAD, the differing working capital ratios set at the reporting date and at later dates may have been agreed with the lenders to reflect the financial fluctuations due to the seasonality of the entity's business. In addition, those stakeholders observe that the

³ Paragraph 72A provides application guidance to paragraph 69(d).

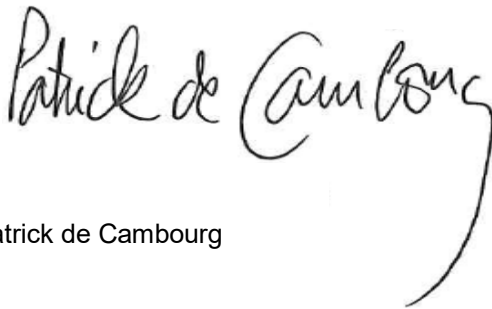
amendments may result, in those circumstances, in counter-intuitive classification outcomes: assuming that the entity meets the covenants that are tested after the end of the reporting period, the entity would first, on the basis of the analysis set out in the TAD, classify the loan as current at the reporting date and would then reclassify this same loan as non-current when then entity tests the subsequent covenants. Consequently, the entity would reverse the classification of the loan during subsequent reporting periods—this would obfuscate the understanding of the entity’s statement of financial position.

Those stakeholders agree that the amendments provide with a simple approach to how an entity assesses the effects of covenants on the classification of its liabilities at the reporting date and accordingly, that such an approach could result in a consistent implementation of the amendments. However, they note that simplicity should not be achieved at the expense of useful information.

Lastly, ANC notes that an entity would be required to apply the amendments for annual reporting periods beginning on or after 1 January 2023, with early application permitted. ANC also notes that those amendments are narrow in scope. Accordingly, ANC thinks EFRAG has still sufficient time to refine its assessment of the amendments before issuing its final endorsement advice (FEA). ANC also understands, on the basis of public discussions, that a number of Committee members questioned whether the amendments would result in useful information in some circumstances and said they would wait for the feedback on the TAD to assess whether to recommend to the IASB any further action in relation to the amendments. ANC thinks this should lead EFRAG to await the next Committee’s deliberations on the TAD before issuing its FEA.

Should you need any further information, please do not hesitate to contact me.

Yours sincerely,

A handwritten signature in black ink that reads "Patrick de Cambourg". The signature is written in a cursive style with a long, sweeping underline that extends to the right.

Patrick de Cambourg