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AUTORITÉ DES NORMES COMPTABLES

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Mrs Sue Lloyd
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December 2020 *IFRIC Update*—Feedback on the Tentative Agenda Decisions

Dear Sue,

I am writing to you on behalf of the Autorité des Normes Comptables (ANC) to express our views on two IFRS Interpretations Committee's (Committee) Tentative Agenda Decisions (TAD) published in December 2020.

There are two appendices to this letter:

- Appendix A sets out our comments in relation to the TAD on *Classification of Debt with Covenants as Current or Non-current*; and
- Appendix B sets out our comments with regard to the TAD on *Attributing Benefit to Periods of Service*.

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

Yours sincerely,

Patrick de Cambourg

Appendix A—Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)

This appendix discusses separately (i) our comments on the technical analysis included in the TAD and (ii) our feedback on whether the requirements in IFRS Standards underpinning this analysis provide useful information.

- **Committee's technical analysis included in the TAD**

We agree with the Committee's technical analysis and tentative conclusion that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine how to classify the loan as current or non-current in the three fact patterns described in the TAD.

- **Reservations about whether the requirements in the amendments to IAS 1 (amendments) result in useful information in the fact patterns described in the TAD**

We think this TAD undoubtedly improves the understanding of the amendments among stakeholders who now have a common and clear understanding of how those amendments will apply in specific circumstances and thus, how they will affect an entity's statement of financial position. Having said that, the TAD also sheds light on what we view as serious flaws of those amendments. We question whether the requirements in paragraph 72A of the amendments that support the Committee's conclusion for cases 2 and 3 provide useful information.

We think this question is worth being asked considering the likely far-reaching effects the amendments may have for an entity—this is 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,(ii) the cost of its debt and (iii) generally its relations with external parties (such as suppliers).

We also consider this question as relevant considering the fact that the outcome of applying the requirements in paragraph 72A came as a real surprise for many stakeholders, acting in good faith. We identified several reasons for this surprise:

- entities have not yet first applied the amendments—they are required to do so for annual reporting periods beginning on or after 1 January 2023—and many of those entities have not even started to assess the likely effects of those amendments.
- the principle underlying the requirements in paragraph 72A was exposed in the ED/2015/1—*Classification of Liabilities* (ED) but as part of its Basis for Conclusions and in a somewhat elliptical manner. As the feedback on the ED indicated[1], there were differing views about how an entity would apply this principle to situations identical, or similar to, those described in the TAD. The final wording in paragraph 72A may improve clarity about the IASB's intentions but, in our view, remains quite challenging to understand without illustrative examples. We also note that the agenda papers the Board considered during its deliberations never clearly illustrated what the implications of paragraph 72A would be in the circumstances described in cases 2 and 3 of the TAD.
- the wording of this paragraph may imply that the requirements only apply when an entity has an obligation at the reporting date but is able to determine whether it meets this obligation only at a later date—for example, the entity has a covenant at the reporting date but compliance with that covenant is verified by reference to the audited financial statements issued at a later date.
- the Basis for Conclusions on the amendments does not, in reality, much comment on the requirements in paragraph 72A. Paragraph BC48E includes specific developments but only in relation to specific circumstances. We reiterate the role of the Basis for Conclusions that we consider as of high importance to help improve a common understanding of the IASB's intentions and accordingly, of the requirements in IFRS Standards.
- the outcome of applying the amendments is so 'counter-intuitive' in some circumstances that stakeholders still question whether the requirements in the amendments faithfully reflect the IASB's intentions.

We also note that some stakeholders already had raised concerns in their comments letters on the ED/2020/3—*Classification of liabilities as current or non-current—Deferral of effective date* published in May 2020 about the differing views on how an entity would apply the amendments to fact patterns similar, or identical to, those discussed by the Committee in the TAD[2]. We think this is additional evidence that the amendments might not have

[1] See in particular paragraph 29 of Agenda Paper 12B for the December 2015 IASB meeting.
[2] 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*

been entirely clear for a number of stakeholders, and accordingly that the outcome of the TAD may conceivably be a surprise for those stakeholders.

We have strong reservations about whether the requirements included in paragraph 72A result in information that is relevant and faithful in cases 2 and 3 of the TAD. The paragraphs below set out a summary of our reservations.

- **There are valid questions about whether the requirements in paragraph 72A faithfully reflect contractual rights and obligations**

The requirements in paragraph 72A result in an entity assessing at the reporting date whether it complies with the conditions that are *contractually* due to be tested at a subsequent date. If the entity does not comply with those conditions at the reporting date, it classifies the loan as current in its statement of financial position at this date. We strongly question whether those requirements faithfully reflect the rights and obligations specified in the loan arrangements described in cases 2 and 3:

- in case 2, the entity has only one covenant that is tested 3 months later. In this case, there is *no* obligation with which the entity has to comply at the reporting date—the covenant cannot contractually be breached at the reporting date, it can only be breached 3 months later. The requirements in paragraphs 72A result in an entity reflecting a 'virtual covenant breach' in its statement of financial position at the reporting date.
- in case 3, the entity does meet, at the reporting date, the covenant that is contractually due to be tested at this date—the entity abides by the obligation existing at this date. However, the entity does not yet meet the covenant that is contractually due to be tested 6 months later. Here again, the requirements in paragraphs 72A result in an entity reflecting a 'virtual covenant breach' in its statement of financial position whereas the entity explicitly complies with the obligations set in the loan arrangement.

In both cases, we note that (i) the lender has no right, at the reporting date, to ask for the repayment of the loan before the contractual date and (ii) the entity has no obligation to redeem it at this same date. A virtual covenant breach arises only because the entity performs a hypothetical covenant test.

The requirements in paragraph 72A result in an entity continuously assessing whether it complies with covenants despite the fact that the entity and the lender have contractually agreed to check such compliance at discrete points in time. In other words, we think the IASB has—consciously or unconsciously—embedded in paragraph 72A the 'creditor's protection argument' whereby an entity's right to defer settlement is implicitly conditional on continuously complying with the conditions specified by the lender even if those conditions are tested on specified date[3]. We recognise the 'prudential' merit of that argument but note it creates rights and obligations that are not specified in the initial contract.

- **Those requirements ignore the 'intended design of the covenants' and thus, may result in information that is not relevant**

The requirements in paragraph 72A result in an entity assessing 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*.

This fundamentally disregards some essential aspects that the parties considered when they agreed on the contractual terms. The timing for the covenant tests and the target values assigned to those tests usually reflect the entity's specific facts and circumstances. In other words, neither the dates for testing nor the target values are defined at random—they reflect the changes both parties expect in the entity's financial performance, position or liquidity by the testing dates. For example,

- in case 2, the parties may have agreed to test the covenant at the end of March because the entity's business is seasonal; and
- in case 3, both the testing dates and the target values assigned to the tests might have agreed as such because the entity has a seasonal business, or is in a recovery situation, or is launching a new activity or is in a start-up phase.

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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'.

[3] Paragraphs 18–23 of Agenda Paper 12B for the February 2016 IASB meeting explain this argument. We note this was the staff's view and accordingly, that this view does not necessarily represent the Board's view.

In both cases, (i) bringing forward the covenant test at the reporting date and (ii) requiring the entity to compare the covenant's target value with the data observed at the reporting date, result in comparing things that cannot be fairly compared. In other words, we think the amendments require an entity to perform a hypothetical test using data that are inconsistent with each other—the entity is required to 'compare apples and oranges'.

The classification the entity would apply to the loan throughout an annual period adds to our reservations about the approach retained by the IASB. If we assume that in cases 2 and 3 the entity meets the covenants tested after reporting date, the entity would first 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. An entity that has a seasonal business would make that reclassification continuously. In our view, this obfuscates the understanding of the entity's statement of financial position and thus, is unlikely to provide relevant information.

- **The requirements in paragraph 72 need to be revisited**

We support the thrust of this standard-setting project. The lack of clarity of the existing requirements in IAS 1 has created diversity in the reporting practices and, by doing, might have obfuscated the understanding of an entity's liquidity. Accordingly, there is a compelling case for standard-setting.

Having said that, we think the approach the IASB has retained for covenants that are to be tested after the reporting date will result in an outcome that many view as counter-intuitive and accordingly, is unlikely to provide useful information about an entity's financial position.

Paragraph 69(d) of IAS 1 currently states that '*an entity shall classify a liability as current when* […] *it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period*…'. We understand, on the basis of public comments and observations, that the IASB tried to make the 'unconditional right' concept operable. Applying the existing requirements in paragraph 69(d) of IAS 1, some may indeed think that an entity would be required to classify *any* loan including covenants that are to be tested after the reporting date as current at the reporting date. This is because the entity 'earns the right' to defer the settlement of the loan for at least twelve months only when the entity successfully performs the covenant test—in other words, the existence of a covenant test after the end of the reporting period might make it impossible for an entity to conclude it has an unconditional right to defer settlement for at least twelve months. We agree that an entity might reach that conclusion reading the existing requirements in paragraph 69(d) in isolation but there are valid questions about whether the resulting classification would provide useful information.

Thus, we appreciate the IASB's efforts to amend the existing requirements by removing the word 'unconditional' and setting a rule for when a right to defer the settlement of a liability exists when that liability is subject to conditions tested after the reporting date. We also appreciate the fact that the IASB tried to develop an approach that entities could easily implement—entities are required to test the covenants using data observed at reporting date and thus, do not need to develop estimates about the data they expect to observe at a later date.

However, we think that a practical outcome has been reached at the expense of useful information and accordingly, that the standard-setting approach underlying paragraph 72A is not appropriate. Simplicity will not make up here for the detrimental consequences of the amendments on useful information. Accordingly, we think the Committee should recommend the IASB to (i) publicly consider the feedback on the TAD and (ii) assess whether to add a narrow-scope standard-setting project to the work plan. In doing so, the IASB might wish to reach out to users to check whether paragraph 72A really cater for their information needs. We think any standard-setting could be limited to reconsidering the requirements in paragraph 72A.

We have identified two possible approaches the IASB may wish to consider if it were to undertake standard-setting:

- applying Approach A, an entity would be required to test, at the reporting date, whether it complies with the conditions that are contractually due to be tested at a later date, within the next 12-month period. In doing so, the entity would test those conditions using estimated data it expects to observe when the conditions are contractually due to be tested. In other words, the entity would assess, at the reporting date, whether it *expects* to comply with those future conditions based on its best estimates. In ANC's view, this approach would respect the 'intended design' of the covenants. It would also be consistent with the approach that underpins requirements in many other IFRS Standards such as IAS *36 Impairment of Assets*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers*, IFRS 16 *Leases* or in IAS 1 itself (for example when an entity assesses whether it is able to continue as a going concern applying paragraph 25 of IAS 21). Applying this approach, an entity would also be required to provide information about key assumptions and sources of estimation uncertainty, in particular in 'close call' situations.

- applying Approach B, an entity would determine the classification of the liability only on the basis of the conditions that are contractually due to be tested at the reporting date. In doing so, an entity would not test, at the reporting date, whether it complies with the conditions that are due to be tested at a later date. In ANC's view, this approach would strictly reflect the contractual rights and obligations and would be easy to implement. Applying this approach, an entity would also be required to provide information about the conditions that are due to be tested after the reporting period—ANC observes that some entities already provide such information when applying the existing requirements in IAS 1.

Appendix B––Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)

We do not entirely agree with the Committee's analysis and tentative conclusion as set out in the TAD. We think that, in the very specific fact pattern described in the submission, the Committee's tentative conclusion is a *possible* view and that an alternative analysis exists.

The TAD specifies that '…[*t*]*he Committee's conclusion aligns with the outcome set out in Example 2 illustrating paragraph 73, which is part of IAS 19*'. We disagree with this statement. We think that the Committee's tentative conclusion only aligns with an excerpt from the above-mentioned example (example 2 in this letter) but not with the example in its entirety. As the Committee's public discussions indicate, the Committee 'crosschecked' its conclusion retaining only a feature of the plan described in this example and that is reproduced in paragraph 28 of Agenda Paper 3 for the December 2020 Committee's meeting—'*A plan pays a lump sum retirement benefit of CU2,000 to all employees who are still employed at the age of 55 years after twenty years of service*…'. However, we think the Committee's ignored another feature of the plan of the example that is: '… *or who are still employed at the age of 65, regardless of their length of service'* (alternative scenario in this letter).

Example 2 illustrates the case of employees who join before the age of 35 and specifies that for those employees *'...service first leads to benefits under the plan at the age of 35 (an employee could leave at the age of 30 and return at the age of 33, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 55 will lead to no material amount of further benefits. For these employees, the entity attributes benefit of CU100 (CU2,000 divided by twenty) to each year from the age of 35 to the age of 55…*".

Example 2 also illustrates the circumstances in which an employee who joins at the age of 55. In those circumstances, we note that such an employee could leave at the age of 57 and return at the age of 60, *with no effect on the amount or timing of benefits*. Instead, we observe that the benefits are only conditional on the employee being employed at the age of 65—accordingly, for employees who join after the age of 55, service before the age of 65 does not lead to any benefits before the age of 65. Applying the Committee's tentative analysis in the TAD, this would result in the entity's obligation to provide benefits arising only when the employee reaches the age of 65 and thus, in the entity recognising the benefit of CU 2,000 when the employee is 65. However, example 2 concludes otherwise and specifies that for such an employee'…*the entity attributes benefit of CU200 (CU2,000 divided by ten) to each of the first ten years'*.

We think essential for the Committee to ensure that, and explicitly explain in any agenda decision, why its analysis tallies with example 2 in its entirety. This is because the Committee's analysis of the requirements in IAS 19 may have widespread effects. In this respect, we note that post-employment benefit plans that entitle employees to receive a retirement benefit when they reach the retirement age provided they are still employed by the entity at that time are common. Some of those plans specify that the benefits may be capped at an amount that is based on a given number of consecutive years of service.

We think that attributing retirement benefit from the date the employee starts working with the entity until the retirement date—regardless of whether that is longer than 16 years—is also an acceptable conclusion for the particular defined benefit plan as described in the submission. This is because:

- when the benefit is a direct consequence of the work contract as supplemented by relevant labour law, the employer incurs an obligation from the employment date onwards, even when the benefits only vest on the date of retirement—or to use the words of paragraph 70(a) of IAS 19, even if the benefits are 'conditional on further service'. If the employees complete all their career with the employer that initially hired them, then the employer is obliged to pay the benefits and only factors outside the employer's control (such as resignation or death) would relieve the employer from that obligation. Despite the fact that an employee joining at 25 will need to work 40 years (assuming that the retirement age is 65) to earn the same level of benefits as an employee joining at 45 who will only have to work for 20 years, each year of service of that employee reduces the amount of future service that the employee will have to render before becoming entitled to the post employment benefit. This suggests that it is appropriate to allocate a service cost for all service periods from the hiring date to the vesting date in accordance with paragraph 72 of IAS 19.

- attributing the ultimate cost of the post-employment benefit over the employees' entire career would also faithfully reflect the underlying economics, ie the average full annual payroll cost of the employee joining at 25 is less than that of the employee joining at 45 because it takes him or her 40 years to vest in the same amount of benefits whereas the employee joining at 45 who will earn the same amount of benefits in only half the period of time (20 years versus 40 years).

- the alternative scenario in example 2 also supports, in our view, that conclusion.

Accordingly, we recommend that the Committee develop further its analysis before finalising the TAD and consider the rationale and merits of the alternative conclusion based on example 2.