ICAEW
REPRESENTATION 18/21

CLASSIFICATION OF DEBT WITH COVENANTS AS CURRENT OR NON-CURRENT (IAS 1)

Issued 11 February 2021

ICAEW welcomes the opportunity to comment on the IFRS Interpretation Committee's' tentative agenda decision regarding the classification of debt with covenants as current or non-current (IAS 1) published December 2020, a copy of which is available from this link.

This response of 11 February 2021 has been prepared by the ICAEW Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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KEY POINTS

1. ICAEW welcomes the opportunity to comment on the IFRS Interpretation Committee's tentative agenda decision regarding the classification of debt with covenants as current or non-current (IAS 1).
2. We have reviewed the three case studies outlined in the tentative agenda decision and agree that based on the facts and circumstances provided in each scenario, the conclusions reached reflect the underlying requirements outlined in the recent amendments to IAS 1 *Presentation of Financial Statements.*
3. While we agree with how the amendments to IAS 1 have been interpreted, we are nevertheless concerned with the resulting conclusions. In particular, that the amendments would bring forward the possible non-compliance of future debt covenants into the current period, even when conditions have not been breached at the year end. In our view this outcome is at odds with the accruals basis of accounting, which paragraph 1.17 of the Conceptual Framework describes as depicting 'the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur…'.
4. The case studies also raise questions around how the amendments to IAS 1 would apply when debt covenants are set in accordance with the business cycle of a company which, for example, may be seasonal. In this case, the position at the year-end may not be a relevant or accurate indicator for future periods. For example, taking case study 3 of the tentative agenda decision, the working capital ratio at 31 December 20X1 meets the covenant at that date, but would not meet the future required covenant at 30 June 20X2, and therefore the debt is classified as current at 31 December 20X1. However, if the debt covenants have been set to reflect the seasonality of the business, the working capital ratio at the year-end might justifiably be very different at 30 June 20X2. In this situation the amendments appear to result in a counterintuitive conclusion.
5. The tentative agenda decision has thrown light on the practical implications of the amendments to IAS 1 and we understand that for many, the result is not what had been expected. Indeed, in our response to the IASB's original proposed amendments to IAS 1 (ED 2015/1) we expressed our view that, under the proposals, an expected future breach would not mean that an existing liability would be presented as current as at the reporting date. We also expressed a general concern over the clarity of the proposals and how this uncertainty might lead to confusion in practice.
6. We believe that the objective in the scenarios examined by the Interpretations Committee should be to communicate to users (i) that the entity is in compliance with its loan covenants at the balance sheet date, and (ii) the risk of possible non-compliance with those covenants in the future and the consequence for the entity if those covenants were breached. We think that the first of these objectives is best achieved through classification of the loan as non-current, and the second through disclosure about the entity's liquidity risks. We recognise that resolving our concerns is a matter for the IASB, rather than one for interpretation by the Interpretations Committee, and so we recommend that the Interpretations Committee refers this matter to the IASB for its further consideration.