Hong Kong Institute of
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.ifrs.org)

18 March 2022

Dr Andreas Barckow
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Andreas,

IASB Exposure Draft ED/2021/9
Non-current Liabilities with Covenants – Proposed amendments to IAS 1

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, and ethics for professional accountants, in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Exposure Draft (ED).

The HKICPA supports the IASB's effort to address the concerns raised by stakeholders about the outcomes and potential consequences of *Classification of Liabilities as Current or Non-current* (2020 amendments) and the related tentative agenda decision published by the IFRS Interpretations Committee in December 2020.

Having said that, we consider that the principle introduced in the ED for the classification of liabilities that are subject to specified conditions within twelve months after the end of the reporting period has not been sufficiently clear, and has inadvertently created the following issues, among others, with the introduction of paragraphs 72B and 72C of the ED.

Firstly, the HKICPA has significant concerns over the notion of "unaffected by the entity's future actions" as currently drafted in paragraph 72C(b) of the ED. This is a new concept in the context of IFRS Standards, yet the ED only provides limited guidance on how to apply this new concept. We consider that the ED is not yet clear as to how an entity assesses the nature and extent of an entity's "ability to affect", and this may lead to a risk of wide interpretation. In addition, questions were raised as to whether common covenants are considered to be "conditions" or events "unaffected by the entity's future actions", and whether paragraph 72B or paragraph 72C(b) of the ED should be applied in those cases.

We note that paragraphs 72B and 72C of the ED are not necessarily mutually exclusive and this is problematic as they would lead to different classification outcomes on the same facts and circumstances. In light of the above, we strongly recommend that the IASB test the proposals with real-life examples and assess whether the resulting outcomes are in line with what the IASB intends to achieve and the ED's objectives; clarify the interaction between paragraphs 72B and 72C of the ED; and clarify the notion of "unaffected by the entity's future actions" in paragraph 72C(b) and the term "conditions" in paragraph 72B with illustrative examples.

Secondly, the HKICPA disagrees with the examples of financial guarantee contracts and insurance contract liabilities stated in paragraph 72C(b) of the ED as this would imply that all financial guarantee contracts and insurance contract liabilities must be classified entirely as current liabilities applying the proposals. We consider that classifying the entire insurance contract liabilities as current liabilities does not reflect the business substance of the insurance contracts, is inconsistent with the requirements in IFRS 17 *Insurance Contracts* and does not provide relevant information to users of financial statements. We also do not consider that all financial guarantee contracts should be classified as current liabilities in all circumstances. Accordingly, we recommend the IASB consider seeking feedback from the insurance industry regarding the classification of insurance contract liabilities and the interaction between the proposal and IFRS 17, and re-consider whether classifying all financial guarantee contracts and insurance contract liabilities as current liabilities, as implied by paragraph 72C(b) of the ED, is appropriate.

Thirdly, the HKICPA disagrees with the proposed separate presentation requirement in paragraph 76ZA(a) of the ED. Instead, we agree with the Alternative Views in paragraphs AV3 and AV4 of the ED that the disaggregation requirements in paragraph 55 of IAS 1 *Presentation of Financial Statements* already set out the principles for presenting additional line items in the statement of financial position when it is relevant to an understanding of an entity's financial position. The proposed separate presentation seems to contradict the principle-based nature of IFRS Standards. We believe that identifying non-current liabilities that are subject to covenants through disclosures in the notes to the financial statements (as proposed in paragraph 76ZA(b) of the ED subject to our comments on that paragraph) would be sufficient for users to identify and assess the risk of those liabilities. Hence, we suggest that the IASB remove the separate presentation requirements in paragraph 76ZA(a) of the ED.

Lastly, the HKICPA does not support the disclosure regarding future compliance with covenants as proposed in paragraph 76ZA(b)(iii) of the ED. This is because we consider that the costs of preparing such disclosure may outweigh its benefits to the users of financial statements, that it requires disclosure of an entity's future behaviour which is arguably beyond the remit of a standard setter and that it may potentially trigger legal obligation if the final outcome is different from that disclosed in the financial statements. We recommend the IASB replace such disclosure with the key factors that may affect the ability of an entity in complying with the conditions after the reporting date. We consider these suggested disclosures would be objective and provide more useful information for users of financial statements to make their own decisions.

Our detailed comments are provided in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me (ceciliakwei@hkicpa.org.hk), Katherine Leung (katherineleung@hkicpa.org.hk) or Joni Kan (jonikan@hkicpa.org.hk), Associate Directors of the Standard Setting Department.

Sincerely,

Cecilia Kwei
Director, Standard Setting Department

Work undertaken by HKICPA in forming its views:

The HKICPA:
(a) issued an Invitation to Comment on the ED on 22 November 2021 to our stakeholders;
(b) sought input from its Disclosure Initiatives Advisory Panel and Financial Instruments Advisory Panel, which are mainly comprised of technical and industry experts and auditors from large accounting firms; and
(c) developed its views through its Financial Reporting Standards Committee, having reflected on its respondents' views. The Committee comprises preparer representatives from various industry sectors, investors, regulators, and technical and industry experts from small, medium and large accounting firms.

Detailed comments on IASB ED/2021/9

Question 1 – Classification and disclosure (paragraphs 72B and 76ZA(b))

Classification (paragraphs 72B and 72C)

1) The HKICPA supports the IASB's effort in addressing the concerns raised by stakeholders about the outcomes and potential consequences of the 2020 amendments and the related tentative agenda decision published by the IFRS Interpretations Committee in December 2020.

2) Having said that, we consider that the principle introduced in the ED for the classification of liabilities that are subject to specified conditions within twelve months after the end of the reporting period has not been sufficiently clear, and has inadvertently created the following issues with the introduction of paragraphs 72B and 72C of the ED.

The notion of "unaffected by the entity's future actions"

3) We have significant concerns over the notion of "unaffected by the entity's future actions" as currently drafted in paragraph 72C(b) of the ED. This is a new concept in the context of IFRS Standards, yet the ED only provides limited guidance in paragraphs BC19 and 20 on how to apply this new concept. We consider that the ED is not yet clear as to how an entity assesses the nature and extent of an entity's "ability to affect", and this may lead to a risk of wide interpretation.

4) In addition, some respondents questioned the meaning of "conditions" in paragraph 72B when determining the scope of paragraph 72B. Specifically, questions were raised as to whether the following common covenants are considered to be "conditions" or events "unaffected by the entity's future actions", and whether paragraphs 72B or 72C of the ED should be applied in these cases.
   i. Loan repayment subject to "completion of IPO" or "a change of control";
   ii. Liability that is repayable when, for example,
      a) the entity fails to meet certain project milestones;
      b) the entity's credit rating deteriorates to a certain level; or
      c) the entity fails to identify the existence of mineral reserves;
   iii. Financial covenants based on the fair value of collateral;
   iv. A very ambitious target, for example, increasing revenue by ten times over the last year; and
   v. Liability with multiple conditions, for example, having both a financial covenant and a "material adverse change in borrower's operation" clause.

5) We and our respondents noted that paragraphs 72B and 72C of the ED are not necessarily mutually exclusive. This is problematic as they would lead to different

classification outcomes.

6) For example, a loan is contractually repayable in five years, but it is repayable on demand if there is a change in control of the entity at any time.
   i. It is arguable that paragraph 72C(b) of the ED is not applicable to such a loan because the entity's future actions may to a greater or lesser extent "affect" whether the controlling shareholder disposes all or some of its equity interest in the entity resulting in a loss of control.
   ii. If one takes the view that retaining the same controlling shareholder is at the discretion of the controlling shareholder, then such a loan would be classified as current applying paragraph 72C(a) of the ED.
   iii. If, in contrast, one takes the view that retaining the same controlling shareholder is a "condition" that must be complied with to allow the entity to defer the settlement of the loan for at least twelve months after the reporting period, then as long as there is no change of control at the reporting date, such loan would be classified as non-current applying paragraph 72B(b) of the ED.

7) As seen from the above example, applying paragraph 72C(a) or 72C(b) (if a change of control is considered to be an event "unaffected by the entity's future actions") of the ED, a long-term loan that is repayable on demand upon a change of control would be classified as current even when there is no actual breach at the reporting date. This outcome seems to contradict the ED's objective that only an actual breach of covenants at the reporting date would lead to a current classification.

8) In addition, some respondents shared that under the existing requirements in IAS 1 *Presentation of Financial Statements*, entities usually apply paragraph 74 of IAS 1 to a long-term loan that is repayable on demand upon change of control and classify such loan as non-current when there is no change of control (i.e. no actual breach). If the IASB were to proceed with the proposals, there would be a significant change to the current practice.

9) Another common scenario is that a long-term loan is repayable on demand if the current ratio is below a certain threshold or if there is a material adverse change in the entity's operation (i.e. with multiple conditions).
   i. Applying paragraph 72B(b) of the ED, such loan would be classified as non-current if the entity complies with both conditions at the reporting date.
   ii. If one takes the view that a material adverse change in the entity's operation is unaffected by the entity's future actions, such loan would be classified as current applying paragraph 72C(b) of the ED.

10) As noted from this example, applying paragraph 72B and 72C separately to loans with multiple conditions could lead to opposite answers – which classification outcome prevails in this case?

11) In light of the above, the HKICPA strongly recommends that the IASB:
   i. Test the proposals with real-life examples (with reference to the examples in paragraph 4 above) and assess whether the resulting outcomes from the proposals are in line with what the IASB intends to achieve and the ED's objectives;
   ii. Clarify the notion of "unaffected by the entity's future actions" in paragraph 72C(b) and the term "conditions" in paragraph 72B;
   iii. Clarify the interaction between paragraphs 72B and 72C of the ED; and
   iv. Clarify how the proposals in the ED should be applied to the examples in

paragraphs 4, 6 and 9 above.

Examples in paragraph 72C(b)

12) Paragraph 72C(b) of the ED specifies that financial guarantees and insurance contract liabilities are examples that would fall within the scope of this paragraph. This may imply that all financial guarantee contracts and insurance contract liabilities would be entirely classified as current liabilities applying the proposals, which may lead to unintended consequences.

13) We disagree with classifying the entire insurance contract liabilities as current liabilities for the following reasons:
    i. An insurance contract usually has a long policy period, especially a life insurance contract, and its liability is determined as the present value of expected future cash flows (among others). Classifying the insurance liability as current would presume that all uncertain future events (e.g. claims) would happen within twelve months after the reporting period. This does not reflect the business substance of the insurance contracts and does not provide relevant information to users of financial statements.
    ii. A long-term insurance contract often has a surrender clause stipulating that a cash surrender value will be paid to the policyholder upon voluntary termination or occurrence of an insured event. Given the nature of long-term insurance and the existence of a surrender penalty, policyholders would normally suffer losses if they surrender an existing life insurance policy, particularly during the early years of the policy. In other words, only a small portion of the surrender value inherent in the insurance contract liability is expected to be settled within twelve months after the reporting period. Under these circumstances, classifying the whole insurance contract liability (the measurement of which might assume the repayment of a much higher surrender value beyond twelve months) as current might result in a net current liability position for the insurer (if it chooses to present the current/non-current distinction on the statement of financial position), which would not be a true and fair presentation of the financial position of the insurance companies.
    iii. According to paragraph 32 of IFRS 17 *Insurance Contracts*, an insurance company measures a group of insurance contracts at the total of two components: a) the present value of fulfilment cash flows (FCF), and b) the contractual service margin (CSM). It is unclear whether paragraph 72C(b) of the ED should be applied to the insurance contract liability as a whole, or to the different components separately, given FCF is associated with cash flows whereas CSM has a similar nature to deferred profit. Hence, classifying the entire CSM component as a current liability for an insurance contract with a coverage period of more than one year would be misleading.
    iv. Insurance companies normally invest in non-current assets so as to match with the liquidity profile of their liabilities. Classifying the whole insurance contract liability as current could be misleading.
    v. Paragraph 72C(b) of the ED implies that entities classify the entire insurance contract liabilities as current liabilities based on the worst case scenario. This is, however, inconsistent with the liquidity disclosure for insurance contract liabilities under paragraph 132(b) of IFRS 17 which is based on the estimated timing of future cash flows.

14) We also do not agree that financial guarantee contracts should be classified as current liabilities in all circumstances. For example, the reporting entity is a guarantor and a related party or business partner of the borrower. It is possible that such special

relationships may allow the guarantor to affect whether the borrower could settle its loans on time, e.g. through the reporting entity's advancing money to the borrower, other forms of prepayments or business activities.

15) Given the above, the HKICPA recommends that the IASB consider seeking feedback from the insurance industry regarding the classification of insurance contract liabilities and the interaction between the proposal and IFRS 17, and re-consider whether classifying all financial guarantee contracts and insurance contract liabilities as current liabilities, as implied by paragraph 72C(b) of the ED, is appropriate. The IASB could also consider one of our respondent's suggestion of introducing an exception by classifying insurance contract liabilities on the same basis as the liquidity disclosure requirements under paragraph 132(b) of IFRS 17.

<u>Interaction between paragraph 72B(a) of the ED and paragraphs 74 and 75 of IAS 1</u>

16) Some respondents raised concerns over the interaction between paragraph 72B(a) of the ED and paragraphs 74 and 75 of IAS 1. For example, an entity enters into a five-year loan with a specific condition to be complied with quarterly. The entity breaches the condition on 31 March 20X1 and obtains a waiver for twelve months till 31 March 20X2. The entity complies with the condition at its reporting date (31 December 20X1).

17) Applying paragraph 72B(a) of the ED, the entity would classify the loan as <u>non-current</u> given the condition is met at the reporting date. However, applying paragraphs 74 and 75 of IAS 1, the grace period provided by the lender is not more than twelve months after the reporting period, and hence the entity would classify such loan as <u>current</u>.

18) Given the above, the HKICPA suggests that the IASB clarify the relationship between paragraph 72B of the ED and paragraphs 74 and 75 of IAS 1, and which paragraph should be applied to the scenario provided in paragraph 16 above.

<u>Meaning of "substance" in paragraph 72A</u>

19) Paragraph 72A of IAS 1 introduces a notion that the right to defer settlement of a liability "must have substance". A few respondents considered that there is no guidance on the meaning of "substance" in IAS 1 which may lead to a risk of different interpretation. We note that the concept of "substance" is not new in the context of IFRS Standards and several standards (e.g. IAS 32 *Financial Instruments: Presentation* and HKFRS 16 *Leases*) contain explicit requirements to take account of the substance of an entity's rights and obligations. However, to enhance consistent application of the proposals, we suggest that the IASB:

   i. explain what is meant by a right that has or does not have substance in the context of current/non-current classification of a liability, e.g. whether it should be viewed from a legal perspective; and
   ii. clarify whether the condition of "a change of control" would be considered to have substance.

<u>"Affect" in IAS 1 vs "control" in IAS 32</u>

20) A few respondents questioned the differences between the requirements for the current/non-current classification of a liability in IAS 1 and the equity/liability classification in paragraph 25 of IAS 32 as both requirements relate to potential cash outflows. In IAS 32, a change in control triggers a financial liability classification when the entity cannot avoid the occurrence of such event (i.e. the worst case scenario), but then this liability would be classified as non-current if the entity can avoid that event occurring in the coming twelve months applying the proposal (i.e. not the worst case scenario). These respondents noted that paragraph BC20 of the ED states that

the meaning of "affect" in paragraph 72C(b) of the ED is not the same as "control" in paragraph 25 of IAS 32, but does not explain why they should be different.

21) In light of the above, we suggest the IASB explain clearly the reasons for the differences between the requirements in the proposal and IAS 32, as well as how they are different in the Basis for Conclusions. We also suggest that the IASB clarify whether the liquidity disclosure for financial liabilities under IFRS 7 *Financial Instruments: Disclosures* should follow the "not within the entity's control" principle or the "affect" principle in the proposal.

Disclosures (paragraph 76ZA(b))

22) Many respondents raised the following concerns with respect to the proposed disclosure on future compliance with covenants in paragraph 76ZA(b)(iii) of the ED:

i. The proposed disclosure may not be useful to users of financial statements because a definitive "yes/no" description of whether the covenants would be met after the reporting period could be misleading.

ii. The proposed disclosure involves forward-looking information which would likely increase the costs for preparers to prepare, and the practical difficulties for auditors to audit, such information.

iii. A respondent is also concerned about the legal implication arising from the proposed disclosure. For example, whether it would trigger any legal obligation of an entity if the final outcome is different from that disclosed in the financial statements (e.g. the entity discloses in the financial statements that management expects to comply with the covenants after the reporting period but it fails to fulfil the condition subsequent to the reporting period).

iv. An investor appreciated the intention of the proposed disclosure but considered that the assessment of whether an entity expects to comply with the conditions after the end of the reporting period is highly subjective and hence, the disclosure may not be useful to users. This respondent also considered that whether an entity expects to comply with covenants in the future might affect the entity's going-concern and in the case of a listed entity, its share price. Therefore, the relevant disclosure should be set and enforced by regulators, instead of the IASB.

23) On the other hand, a minority of the respondents supported the proposed disclosure. They disagreed with the arguments in paragraph AV5 of the ED for the reason that recent IFRS Standards also require the incorporation of forward-looking information to measurement, e.g. expected credit loss in IFRS 9 *Financial Instruments*. A respondent further considered that the argument in paragraph AV5 that users of financial statements should be capable of assessing the risk that a condition may be breached based on the proposed disclosures supported by an analysis of financial reports along with additional economic information would not work for certain non-financial covenants, e.g. reaching milestones for developing a generic drug.

24) The HKICPA acknowledges the concerns raised by our respondents in paragraph 22 above, in particular, the costs and benefits considerations and the potential legal implication of pursuing the proposal. In light of this, we recommend the IASB replace the proposed disclosure in paragraph 76ZA(b)(iii) of the ED with the disclosures of key factors which may affect the ability of an entity in complying with the conditions after the reporting date. We consider these suggested disclosures would be objective and provide more useful information for users of financial statements to make their own decisions.

25) In addition, we recommend the IASB consider improving liquidity disclosures under

paragraph B11C-11F of IFRS 7 and defaults and breaches of loan covenants under paragraphs 18-19 of IFRS 7 by requiring additional disclosures of covenants in the absence of a breach and the associated risks. This would improve the interaction between IFRS 7 and IAS 1, and address the concerns stated in paragraph BC21 of the ED.

Question 2 – Presentation (paragraph 76ZA(a))

26) We disagree with the proposed separate presentation requirement in paragraph 76ZA(a) of the ED. Instead, we agree with the Alternative Views in paragraphs AV3 and AV4 of the ED that the disaggregation requirements in paragraph 55 of IAS 1 already set out the principles for presenting additional line items in the statement of financial position when it is relevant to an understanding of an entity's financial position. The proposed separate presentation seems to contradict the principle-based nature of IFRS Standards.

27) We support identifying non-current liabilities for which the entity's right to defer settlement for at least twelve months after the reporting period subject to compliance with specified conditions within twelve months after the reporting period through disclosures in the notes to the financial statements. We also consider that providing the proposed disclosures in paragraph 76ZA(b)(i) and (ii) of the ED, together with our recommendations in paragraphs 24 and 25 above, would be sufficient for users to identify and assess the risk of those liabilities. Hence, we suggest that the IASB remove the separate presentation requirements in paragraph 76ZA(a) of the ED.

Question 3 – Other aspects of the proposals

Transition and effective date

28) The HKICPA has no major comments on the retrospective application and the deferral of the effective date of the amendments to IAS 1.

~ End ~