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Brasília, Distrito Federal – Brazil

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September 30, 2015

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International Accounting Standards Board (IASB)

30 Cannon Street

London EC4M 6XH

United Kingdom

Dear Board Members,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] submitted to the Board a comment letter related to the ED 2015/1 – Classification of Liabilities – Proposed Amendments to IAS 1 in June 8, 2015. After several discussions, CPC decided to further explore the conceptual rationale behind the classification of liabilities when there is a breach in covenants in loan arrangements, and kindly request that the Board analyze our point of view enclosed in this letter.

For convenience purpose, we also attach our original letter submitted on June 8, 2015.

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1 The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

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If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Silvio Takahashi

Chair of International Affairs Comitê de Pronunciamentos Contábeis (CPC)

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CPC letter to IASB on IAS 1 – Paragraphs 74 to 76 – Covenants in loan arrangements

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1. PUTTING IAS 1 INTO PERSPECTIVE

The exclusively literal interpretation of IAS 1, more specifically of paragraphs 74 to 76, suggests that violation of covenants in agreements to raise long-term funds is a sufficient condition for such funds to be reclassified to current liabilities, regardless of any reset between the balance sheet date and that of the financial statements, in light of the prevalence of a solely and only formalistic reading detached from the essence of the economic phenomena occasionally seen nearby.

Accordingly, some preliminary clarification is a must, in order to put into perspective any and all requirement from international accounting standards, vis-à-vis the primary objectives of this set of provisions.

Observing the qualitative features set out in the conceptual framework is a unique activity aimed at reaching and maintaining the validity of the useful accounting and financial information concept. These features encompass: i) relevance; ii) materiality; and iii) faithful representation.

Still considering the clarification in the aforesaid pronouncement, item QC4 is worth wording verbatim:

> QC4. If financial information is to be useful, it must be relevant and **faithfully represent what it purports to represent**. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. (**emphasis supplied**).

In light of this precedent, there is a hard evidence of what the IFRS “principles-based nature” is all about, entailing that the preparation of the financial statements should be guided by coherent guidance on recognition, measurement and disclosure of economic and/financial events, rather than only through formal reading that leads to straightforward box-ticking without any judgment of value when choosing accounting practices for recognition and disclosure. Also, worth noting is that the primary conceptual guidance that has inspired and still inspires the IFRS and their effects on the national accounting system stem from the assumption that any accounting record is valid and relevant only if supported by robust economic grounds (“*accounting follows economics*”). Likewise, the preparation of accounting reports under the guidance of such system should depict the economic types and features, which again should support each entity’ accounting records and eventually allow the organization to be clearly seen

as one which raises and invests funds, produces cash flows and increases or reduces its equity by generating profits or losses.

Still with regards to faithful accounting information, the same document sets out three unequivocal conditions to attain such information, to wit:

> QC12. Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent phenomena that it purports to represent. To be a perfect faithfully representation, a depiction would have three characteristics. It would be *complete*, *neutral* and *free* of error. Of course, perfection is seldom, if ever, achievable. The board's objective is to maximize those qualities to the extent possible.

As completeness is concerned, all necessary information should be provided for an economic and financial event to be understood and its full impact. As neutrality is concerned, predisposition is focused on the absence of biased selections which lead and therefore skew the perceptive understanding of the financial statement users and eventually leads them to make wrong decisions. Finally, the mention of the term free of error warns us that this concept is not assigned accuracy in all aspects (which would be virtually impossible, since "accuracy" does not coexist alongside principles-based standards arising from judgments in their own right), but rather the accounting procedures used should be free of skew acts by an Entity's management, which would otherwise impair meeting the key objectives of the accounting information.

Despite of essentialist instructions on the treatment of events which affect an organization's equity, set out by the IFRS conceptual framework, it is somehow confuse and strange to find in those standards disparate gaps in form and content of this philosophy, narrowed by guidelines usually stemming from other accounting systems of a coding essence.

The insights into these conflicting and misaligned guidance of the Conceptual Framework often found in the provisions of certain IAS/IFRS include the aforesaid obligation to reclassify agreements from noncurrent liabilities to current liabilities, in case of one-off violation of certain covenants[2], disregarding the entire scenario the Entity operates in, as follows:

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[2] Vide: Skinner, D. J. (2011). **Discussion of "Accounting standards and debt covenants: Has the "Balance Sheet Approach" led to a decline in the use of balance sheet covenants?** Journal of Accounting and Economics, 52, 203-208.

i) ***Maintenance of the organization's ability to pay***: there may be companies that provisionally, specifically and temporally violate a covenant, but demonstrate broad and full ability to settle short-term liabilities;

ii) ***History of early maturity of debts by creditors***: the link between creditors and their customers makes up a complex inter-relation, taking into consideration factors such as timeline of successful financial relationship, brand trustworthiness, sponsors or guarantors, among other conditions directly affecting the exercise of corporate policies between both.

iii) ***Nature or origin of creditors***: occasionally, significant funds are raised from promotion or development banks, with no claim, at least in their letters of corporate values, to generating market disorders by taking a predatory stance, mainly when stemming from an out of context, rushed and formalistic reading of the standard-setting guidance; and

iv) ***Static condition of covenants***: covenants are executed as funds are granted, and not necessarily revised later, thus losing not only their effectiveness, but also timeliness vis-à-vis the evolvement of the scenario at the time they are observed.

Also worth noting is that the group of essential conditions to obtain a faithful representation as set out in the Conceptual Framework includes neutrality, which can also be understood, notwithstanding a rushed generalization, as a behavior other than the principle of prudence seen as conservatism. That is, there is no question of adopting at the neutrality level conservative or enterprising stances, but rather subjective judgments that better express and characterize the economic events present in a company.

By the way, the "conservatism" existing in the past, which always recommended to choose the highest liability or the highest expense, whenever available, and the lowest asset and the lowest revenue, in the opposite case, is definitely ruled out of the universe of principles-based standards – it is not uncommon that grounds exist for the preparer and auditor of financial statements to choose, in some instances, the LOWEST liability/expense or the HIGHEST asset/revenue.

Accordingly, establishing a provision like that set forth in paragraphs 74 to 76 of IAS 1 collides head-on with the idea of neutrality, as it intrinsically brings along a high burden of

formalistic bias, leaning heavily towards exaggerated conservatism, typical of regimes which give little importance to the accounting information[3], as the IFRS themselves provide for otherwise.

In fact, even if the figure of Prudence, in its genuine and acceptable conception, should be understood as driving a stance that increases the *trustworthiness* of the financial statements, never to cast willful bias upon it.

In view of the foregoing, the subject matter of this opinion is not to rule out those provisions in connection with a discretionary and convenient application, nor is it to resort to fallacious arguments on the accounting standard for it to fit into preset situations. The heart of this digression lies in the technical elevation of this discussion to address environmental aspects, which are deemed to be key when looking into the overall inapplicability of the commands set forth in the aforesaid paragraphs of IAS 1.

2. *CONTRACTUAL THEORY OF THE FIRM AND COVENANTS*

Sunder[4] (1997) points out that a company is a set of expressed or implied contracts which trigger a two-way path commensurate with the actions that affect the organization and its stakeholders.

From that perspective, such contracts would encourage the creation of clauses aimed at predictively assessing the wholesome maintenance of such relationship, specifically focusing on liquidity, solvency and indebtedness level of the debtor, among other indicators, as creditors are concerned.

Watts and Zimmerman[5] (1990) agreed upon calling these clauses as contractual costs, which would cause cross influences not only in the entities' financial management, but also in the resulting selection of accounting choices that might be determined solely and only by the convenience of meeting these covenants, thus impacting the significance of accounting figures.

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[3] BALACHANDRAN, S. and MOHANRAM, P. (2011). **Is the decline in the value relevance of accounting driven by increased conservatism?** Review of Accounting Studies, 16(2), 272-301.

[4] Sunder. S. (1997). **Theory of accounting and control**. South-Western Publishing

[5] Watts, R. and Zimmerman, J. (1990). **Positive accounting theory: a ten year perspective**. The accounting review, 65 (1), 131-156.

Based on this theoretical intersection, different empirical studies were produced, aiming at gaining an understanding, among other aspects, of what primarily leads to the breach of covenants of loan arrangements, as well as the consequences from such situation (e.g. CHEN & WEI[6], 1993; SWEENEY[7], 1994; HALL & SWINNEY[8], 2004).

Specifically as regards the 'punishments' or effects from violation of contractual clauses, the researches indicate that there is no uniformity of impacts therefrom. There may be cases in which guarantees are increased, restrictions are applied to raising new loans, interest rates are increased, additional covenants are imposed, contracts are settled early, and in certain situations, waivers are generally granted by creditors for valuable consideration.

The varying number of findings stemming from these studies indicates multiple cases in which contractual clauses may be violated; the same results make clear that most severe situations require early settlement of financing, like others in which a covenant may be violated solely due to its timelessness or one-off, case-by-case, momentary and short-lived occurrence, with further compromise by the creditors. This situation can be found more often in cases in which raised funds are repaid in the short term, chiefly by formulating parameters not existing when the agreement was executed. Furthermore, there is evidence that they will not necessarily continue so when compared with the results posted by a company for various periods.

If all this takes place in case of breach, that is, there is a large array of consequences upon a breached covenant, since allowing this environment riddled with doubts when it is already known, at the balance sheet date, that none of these troubles remain?

Worth noting is the escalation of inconsistencies involving the accounting treatment imposed by the breach of a contractual clause, but already settled on the date the user becomes aware of the financial statements. Since the commonly named breach of covenants stems from such a diversified source, a question is raised on the propriety, fairness and effectiveness of an unexpected and supposedly unison accounting rule to be applicable in the

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[6] Chen, K, and Wei, K. C. J. (1993). **Creditors' decision to waive violations of accounting-based**. The Accounting Review, 68(2), 218-232.

[7] Sweeney, Amy P. (1994). **Debt-covenant violations and managers' accounting responses**. Journal of Accounting and Economics, 17(3), 281-308.

[8] Hall, S. and Swinney, L. S. (2004). **Accounting policy changes and debt contracts**. Management Research News, 27(7), 34-48.

precise opposite situations – would be a reprehensible step backwards to past-dwelling rules-based standards.

The result is evident and unequivocal: such impositions end up increasing discretionary in other realms of accounting choices, aimed at complying with such clauses at the expense of information trustworthiness.

2.1. Evolutionary effects of IAS 1 (paragraphs 74 to 76) and other provisions

The following passage addresses the aforesaid paragraphs exactly as reported in IAS 1, to wit:

74. When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the **liability becomes payable on demand**, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, **it does not have an unconditional right to defer its settlement for at least twelve months after that date**;

75. However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

76. In respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date the financial statements are authorized for issue, **those events are disclosed as non-adjusting events** in accordance with IAS 10 Events after the Reporting Period:

(a) refinancing on a long-term basis;

(b) rectification of a breach of a long-term loan arrangement; and

(c) the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ending at least twelve months after the reporting period. (**emphasis supplied**).

In essence, it is possible to note that the standard ultimately seeks to hinder situations in which the companies are subject to early settlement of a debt, at the creditors' discretion, without the companies warning other stakeholders of this situation.

In accordance with the red book, these paragraphs were originally issued upon the introduction of IAS 1 back in 1997 and slightly revised in 2002. Such long-lived text has been in force and unrevised for nearly 13 years now, preceding also the joint initiative between FASB and IASB to approve a Conceptual Framework for Financial Reporting kicked off in 2006.

The anachronistic provision in paragraphs 74 to 76 of IAS 1, vis-à-vis the principles-based contents of the Conceptual Framework*,* sheds light into more than a simple mismatching of deadlines among standards, since, in accordance with the taxonomy to formulate an IFRS, the stages of proposal or revision of a document are strongly influenced by the wording of the Conceptual Framework. Thus, inconsistencies between the period of issuance of a general standard and that of specific rules would shape a fruitful environment for misalignment of purposes within the same set of accounting standards.

Situations clashing with the logics of an accounting treatment in light of a true and fair view, as described in the context of this material, are addressed by IFRS, including in IAS 1 itself, paragraphs 19 and 20, as shown in the passage below:

19. In the extremely rare circumstances in which management **concludes that compliance with requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework*****k*****, the entity shall depart from that requires, or otherwise does not prohibit, such a departure.**

20 When an entity departs from a requirement of an IFRS in accordance with paragraph 19, it shall disclose:

(a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

(b) that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;

(c) the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and

(d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement. (emphasis supplied).

This mechanism is known as true and fair override (TFO). According to Alexander e Archer[9] (2003), the TFO is a meta-rule, a principle to be followed when setting the framework for and applying the accounting standards (lower-layer rules), as well as for the violation of some of these rules.

Yet there are a few events known involving the application of the TFO addressed in IAS 1, there are precedents that its employment was the sole alternative not to apply specific IFRS guidelines which would lead to lack of information or misinformation and, as a consequence, to errors by readers of accounting documents, with actual losses to organization as the standard-setting provisions fail to fully cover certain cases (e.g. Deutsche Post AG, Germany, in 2006; Société Générale, France, in 2007; HSBC, United Kingdom, in 2009; National Express, United Kingdom, from 2005 to 2010; Go-Ahead Group PLC, United Kingdom, from 2005 to 2013).

This clearly shows the robustness of international accounting standards, combined with a very informative reasoning line by the International Accounting Standards Board (IASB) – about the importance of a global accounting harmonization process. It is advisable that companies from different countries are brought into the same loop of standards that drive the issuance of accounting reports, especially to secure more straightforward financial flows among the various capital markets. However, yet this is basically a legitimate claim, it should be considered that it is an unabashed one, since nearly 138 jurisdictions are currently conjured up of formal and informal entities opting for IFRS. A command equal to that of true and fair override is a primary and essential condition to secure that this global movement converges, if not fully at least mostly, to meet its primary purpose.

However, worth pointing out is the huge difficulty to actually implement this true and fair override. It is an extreme case that company management boards, independent auditors and even regulators tend to avoid.

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[9] Refer to: Alexander, D., & Archer, S. (2003). **On economic reality, representational faithfulness and the "true and fair override"**. Accounting and Business Research., *33*(1), 3-17.

According to the formal requirements set forth in paragraphs 74 to 76 of IAS 1, many companies shall tread this hard path as the sole possible exit not to have their financial statements unfairly affected.

3. *FINAL COMMENTS*

In view of the factors exposed throughout this report, it is unacceptable to require reclassifications to current liabilities in connection with one-off violation of covenants whenever economic and business circumstances, if any, result in such reclassifications not fully reflecting an entity's actual economic and financial information.

Therefore, formalistically deploying such general accounting rule not only skews the significance of the financial statements, but also may bring actual losses to the organizations, as other creditors, in connection with such reclassification, may misinterpret that a company is experiencing insurmountable financial restrictions and require its rights to be early settled[10], causing a wide range of misstatements.

In light of the grounds reported throughout this paper, we suggest that the application of the guidelines addressed in paragraphs 74 to 76 of IAS 1 be modified, allowing the retroactive consequence of a subsequent event which is able to remove the dire consequences of a covenant flagged as "breach" at the balance sheet date, but no longer so at the time the financial statements are issued. Accordingly, the following wording is proposed for paragraph 75 of the aforesaid standard:

> Nevertheless, the liability shall be classified as noncurrent if the creditor has agreed, **no later than the date of approval of the financial statements**, to provide an extension of deadline, ending at least twelve months after the balance sheet date, within which the entity may amend the breach of covenant CPC_26_R1contratual (realignment within the indebtedness and interest hedge ratio, for example), during which the credit shall not require the prompt settlement of the liability in question.

[10] *Cross-default*

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Enclosed herewith is the Comment Letter sent in June 2015

June 8, 2015

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IFRS Foundation

30 Cannon Street

London EC4M 6XH

United Kingdom

Subject: Proposed amendments to IAS 1

Reference: Classification of Liabilities

Dear Board Members,

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[11] welcomes the opportunity to respond to this exposure draft.

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11 The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), BMFBOVESPA (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

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We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

Our detailed responses to the specific questions posed in the ED are set forth in the following pages.

We also state our view about the basis for conclusion and ask for a deeper analysis of the board in the covenants issue.

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Silvio Takahashi

Chair of International Affairs Comitê de Pronunciamentos Contábeis (CPC)

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Question 1—Classification based on the entity's rights at the end of the reporting period

The IASB proposes clarifying that the classification of liabilities as either current or non-current should be based on the entity's rights at the end of the reporting period. To make that clear, the IASB proposes:

(a) replacing 'discretion' in paragraph 73 of the Standard with 'right' to align it with the requirements of paragraph 69(d) of the Standard;

(b) making it explicit in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and

(c) deleting 'unconditional' from paragraph 69(d) of the Standard so that 'an unconditional right' is replaced by 'a right'.

Do you agree with the proposed amendments? Why or why not?

Answer to question 1

We agree with the exchanges proposed (a), (b) and (c).

Question 2—Linking settlement with the outflow of resources

The IASB proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding 'by the transfer to the counterparty of cash, equity instruments, other assets or services' to paragraph 69 of the Standard. Do you agree with that proposal? Why or why not?

Answer to question 2

We agree. Nevertheless we would appreciate the board discussion, and conclusion, about how a liability settlement would impact the classification of this element, in current or non-current. In our view, this definition is important, but it seems to fit better in the project of conceptual framework improvement.

Question 3—Transition arrangements

The IASB proposes that the proposed amendments should be applied retrospectively. Do you agree with that proposal? Why or why not?

Answer to question 3

We agree.

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Comments to be added

Yes, we agree with the proposed amendments and transition application proposed. Nevertheless, we have the following specific comment:

Covenants issue

We believe that if a debt arrangement is renegotiated after year-end (e.g. a waiver was obtained for a covenant default), but before the release date of the financial statements, should be classified as non-current liability at year end in order to provide meaningful information to the users of the financial statements. In many cases, entities realize that they are in default after the preparation of the financial statements, thus after year-end, and immediately request a waiver to the counterparty, obtaining such waiver before the release date of the statements. In paragraph 73 (R) the Board express its view that said waiver is not a company "right" at the end of the report date, and as such, the company should classify the debt breach as a current liability. We kindly request that the Board reassess such issue in this revised standard. We believe that classifying the debt as a current liability, and disclosing the waiver in a subsequent event note may not be fully meaningful for the user of the information in this specific scenario, and in fact, will provide incorrect and misleading information to such user.

We would like to propose the exchange of the matter contained on paragraph 73R (a) to paragraph 72R with the following wording:

"When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, if the lender agreed not to demand payment as a consequence of the breach, after the reporting period and before the authorisation of the financial statements for issue, it classifies the liability as non-current. An entity classifies the liability as non-current because, although at the reporting date, the entity did not have a right to defer its settlement for at least twelve months after that date, before the issuance of the financial statements such right was granted by the lender, providing more useful information to the users of the information, while meeting the provisions of IAS 10 – Events after the Reporting Period."