

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG FR Board or EFRAG FR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG FR Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

ED/2021/09 Non-Current Liabilities with Covenants Cover Note

Objective

- 1 On 19 November 2021, the IASB published Exposure Draft/2021/09 Non-Current Liabilities with Covenants (the ED), with a 90-day comment period ending on 21 March 2022, where the IASB proposes to amend IAS 1 Presentation of Financial Statements.
- 2 On 18 January 2022, in its response to the ED, EFRAG published its Draft Comment letter on the ED (the DCL) with the deadline for comments on 9 March 2022.
- 3 The objective of the session is to:
 - (a) provide EFRAG FR TEG members a summary of the feedback received;
 - (b) discuss the EFRAG Secretariat proposal to finalise EFRAG's Comment Letter on the ED (the FCL);
 - (c) recommend EFRAG's Comment Letter to the EFRAG FR Board for approval.

Background of the IASB project

- 4 In January 2020 the IASB issued Classification of Liabilities as Current or Non-current (2020 amendments). The 2020 amendments clarified aspects of how entities classify liabilities as current or non-current; especially how an entity assesses whether it has the right to defer settlement of a liability when that right is subject to compliance with specified conditions within twelve months after the reporting period.
- 5 In a submission to the IFRS Interpretations Committee questions were raised about the application of the 2020 amendments in particular fact patterns. Respondents to the tentative agenda decision raised concerns about the outcomes and potential consequences of the 2020 amendments in some situations (e.g., when covenants are negotiated that will have to be complied with after the reporting period end due to seasonality reasons). The Committee reported this feedback to the IASB, highlighting new information (seasonality) that the IASB had not considered when developing the amendments.
- 6 In November 2021, the IASB published the ED/2021/09 which aims to improve the information an entity provides when its right to defer settlement of a liability for at least twelve months is subject to compliance with conditions, in addition to addressing concerns about the classification of such a liability as current or non-current.
- 7 In the ED the IASB:
 - (a) has maintained the requirement that an entity's right to defer settlement must have substance (introduced in the 2020 amendments);

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- (b) retains the classification of current and non-current based on the borrower right to defer payments based on the situation as of the end of the reporting period for at least a twelve-month period after the end of the reporting period;
- (c) clarify that
 - (i) certain liabilities with specified conditions to be complied with at the reporting period end but tested after the end of the reporting period affect the entities right to defer payments for more than 12-month after the reporting period and may lead to a current classification (paragraph 72B(a) of IAS 1);
 - (ii) certain liabilities with specified conditions to be complied with after the reporting period end do not affect the entities right to defer payments and lead to a non-current classification (paragraph 72B(b) of IAS 1);
 - (iii) certain liabilities that may become payable within the 12-month period after the end of the reporting period are to be classified as current if they are payable at the discretion of a third party or if the borrower cannot affect the outcome of the occurrence of an uncertain future event that causes payment within 12-months after the reporting period end (paragraph 72C of IAS 1).
- (d) propose a separate presentation within the non-current heading of the balance sheet to highlight the information that some non-current liabilities (under paragraph 72B(b)), due to contractual conditions, may become current within the 12-month period after the end of the reporting period;
- (e) provide disclosure requirements for non-current financial liabilities that may become repayable within twelve months, e.g., forward looking information whether and how an entity will comply with a covenant in the period after the reporting period end.

Background of the EFRAG discussions and outreach

- 8 EFRAG has undertaken different measures to receive sufficient feedback to decide on the finalization of the comment letter (the FCL). EFRAG held public meetings with working groups after publishing the DCL:
 - (a) EFRAG held a meeting with EFRAG FR TEG-CFSS on 17 February 2022;
 - (b) EFRAG held a meeting with the EFRAG Academic Panel on 4 March 2022;
- 9 Moreover, EFRAG also held other outreach in closed meetings (e.g., a closed User Panel Event) with constituents and published a survey where eight respondents replied. The analysis of the results of the survey, the other outreach as well as the analysis of the working group meetings can be read in Agenda Paper 04-03.
- 10 At the time of writing, six comment letters in final version and four letters in draft version have been received which have been considered for the present summary of feedback but are not published to EFRAG's website. The analysis of the comment letter can be read in Agenda Paper 04-02.
- 11 EFRAG published a draft comment letter on the proposals on 18 January 2022. In the draft comment letter, EFRAG held the following views:
 - (a) Supporting the IASB's efforts to address the concerns of constituents that have emerged in the context of the IFRS Interpretations Committee's agenda decision of December 2020.
 - (b) Accepting that liabilities should be classified as current or non-current based on the situation as at the end of the reporting period.
 - (c) Not supporting paragraph 76ZA(a) which requires a separate presentation on the face of the statements of financial position of the liabilities classified as

non-current for which the entity's right to defer settlement for at least twelve months after the reporting period is subject to compliance with specified conditions within twelve months after the reporting period, as this proposal contradicts the principles-based nature of IFRSs.

- (d) EFRAG is sympathetic with the concerns about providing forward-looking information with respect to future compliance with covenants as also expressed in the ED's alternative view and is proposing an alternative wording for paragraph 76ZA(b)(iii).
- (e) Disagreeing with paragraph 72C(b) and encouraging the IASB not to use the notion of "unaffected by the entity's future actions", as there is a substantial risk that the proposed wording will not preclude a divergent interpretation based on facts and circumstances by different entities.

EFRAG Secretariat proposed recommendation

- 12 The following EFRAG Secretariat proposals regarding how to finalise EFRAG's FCL are based on the outreach feedback received from constituents, the comment letter responses, and from the EFRAG meetings (TEG and TEG/CFSS).

Overall

- 13 The outreach confirmed that constituents share the concerns raised by the respondents to the IFRS IC tentative agenda decision as the 2020 amendments fail to faithfully represent an entity's financial position at the reporting date, so EFRAG Secretariat recommends to retain the position to welcome the IASB's amendment.

Classification

- 14 EFRAG Secretariat has assessed during the outreach that the concept of substantive rights as expressed in paragraph 72A of IAS 1 – which was introduced as part of the 2020 amendments - is less clear than originally envisaged. EFRAG Secretariat holds the view that the application of the term is not fully investigated with regard to its implication on the classification requirements and the forward-looking disclosures. Therefore, EFRAG Secretariat recommends to add guidance and/or example on how to apply the "substantive right" requirement in paragraph 72A, especially with regard to
- (a) clarification of the term;
 - (b) it's interaction with paragraph 72B(b): could 72A restrict liabilities from falling under 72B(b) so that these would have to be classified as current as a consequence of the lacking substance; and
 - (c) the concept of "substance rights" and how it interacts with the forward-looking disclosure requirements.
- 15 EFRAG Secretariat perceived a broad support for paragraph 72B(b) so that conditions with which an entity must comply within twelve months after the reporting period shall not affect classification of a liability as current or non-current. But EFRAG acknowledges that paragraph 72B(b) is a rule or convention set by the IASB which might not result in a faithful presentation in all cases but which could probably be corrected by the application of paragraph 72A (see paragraph 14 above).
- 16 EFRAG Secretariat as stated in the draft comment letter agrees to paragraph 72C(a) and sees support for the paragraph basic message as a result of the given feedback. EFRAG will highlight this in the final comment letter but will also recommend a change in the wording as suggested below.
- 17 EFRAG Secretariat continues to hold the view that the classification guidance given in paragraph 72C(b) with regard to the term "affected/unaffected" is

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- (a) not clear and probably inappropriate as it could also be applicable to common clauses like “force majeure”;
- (b) introduces a new concept; and
- (c) is also not compatible with principle based standard setting; and
- (d) will result in diversity in practice.

EFRAG suggests to not base the main explanation for differentiation in paragraph 72C(b) on the words “affected” or “unaffected”, but to delete paragraph 72C and relocate paragraph 72C(a) to paragraph 72B(c) with the following wording:

“affect whether that right exists at the end of the reporting period when the counterparty or a third party has an unconditional and enforceable right to impose repayment at the end of the reporting period”

EFRAG also recommends the IASB to consider adding to 72(B) a new paragraph covering the following:

“affect whether that right exists at the end of the reporting period when the counterparty or a third party has a right to impose repayment which will become unconditional within twelve months after the reporting period solely as a result of the passage of time”

- 18 EFRAG Secretariat as well as several constituents support that the example of insurance liabilities in paragraph 72C(b) of IAS 1 should be eliminated even if the IASB will continue with the proposals.
- 19 Based on the feedback received EFRAG Secretariat recommends to the IASB to clarify the interaction of paragraph 72B and paragraph 75 of IAS 1. EFRAG Secretariat is aware that paragraph 75 of IAS 1 is not part of the narrow scope amendment but requests the IASB to closer investigate the interaction of both standard and their consistency of respective outcomes.
- 20 EFRAG Secretariat ultimately agrees to the constituents’ concerns raised with regard to paragraph 69(d) being the original root cause, therefore EFRAG Secretariat recommends highlighting in the final comment letter that the amendment would not solve the original problem. Simultaneously, EFRAG Secretariat is cognisant of the narrow scope character of the project and will therefore recommend to debate the broader issue in the primary financial statements project.

Disclosure

- 21 Due to the comments received EFRAG Secretariat sees support for the disclosures as stated in the proposals in general to enable users to understand the risk that a liability may become repayable within twelve months after the reporting period end. The disclosures were generally perceived as useful information for financial statement users. Therefore, EFRAG will retain its view about the usefulness of information. However, EFRAG acknowledges that constituent’s views are split with regard to the disclosure of forward-looking information.
- 22 Based on the assessment EFRAG Secretariat recommends to retain with its position regarding paragraph 76ZA(b)(iii) to only require a statement on “whether” an entity expects to comply with the specified condition. EFRAG Secretariat recommends to promote consistency between the standards and therefore recommends to consider for the assessment of “whether” an entity expects to comply all facts and circumstances based on the guidance given in IAS 10, which differentiates between adjusting and non-adjusting events.
- 23 EFRAG also recommends to the IASB to further investigate the interaction of this disclosure requirement and the requirement in 72A to have a “substantive right”. EFRAG Secretariat has the concern that the requirement to have a substantive right would contradict the disclosure requirement in 76ZA(b)(iii) (on the statement

“whether” an entity expects to comply). If the entity does not expect to comply with the specified condition it should first be assessed whether in such cases a substantive right would exist (e.g., whether this would ultimately result in a current classification). If the answer would determine the classification the disclosure requirement would not be applicable and useful anymore. Here EFRAG Secretariat refers to the classification section where a better explanation of the concept is recommended.

- 24 EFRAG Secretariat is also aware that constituents have different opinion about the scope of the liabilities for which disclosures should be required (all liabilities or a subset of liabilities). Thus, EFRAG Secretariat recommend to limit the scope of disclosures to those non-current liabilities where “significant uncertainties” exist whether the entity will comply with the specified condition within 12-month after the reporting period end.
- 25 EFRAG Secretariat has noted the disclosure requirements relating non-adjusting events in paragraph 76 of IAS 1 should be updated for the regulation in paragraph 72B(b) of IAS 1.

Presentation

- 26 Based on the comments received EFRAG Secretariat sees strong support to continue with our recommendation to not require separate presentation.

Other aspects

- 27 EFRAG Secretariat retains it’s position with regard to other aspects of the proposal especially with regard to retrospective application. However, EFRAG Secretariat recommends to the IASB to make a clarifying statement by the IASB in the standard that both amendments could only be applied together as a package to align the effective date for the two amendments.

Questions for EFRAG FR TEG

- 28 Does EFRAG FR TEG agree with the recommendations regarding the finalisation of the comment letter?
- 29 Does EFRAG FR TEG recommend EFRAG’s (Draft) Final Comment Letter for the EFRAG Board to approve?

Next steps

- 30 Present (Draft) Final Comment Letter to EFRAG FR Board for approval and publication.

Agenda Papers

- 31 In addition to this cover note, agenda papers for this session are:
 - (a) Agenda paper 04-02 – Non-Current Liabilities with Covenants - Comment Letter Analysis 23.03.2022;
 - (b) Agenda paper 04-03 – Non-Current Liabilities with Covenants – Analysis of Other Feedback 23.03.2022; and
 - (c) Agenda paper 04-04 a – Non-Current Liabilities with Covenants – Final Comment Letter track change 23.03.2022.
 - (d) Agenda paper 04-04 b – Non-Current Liabilities with Covenants – Final Comment Letter 23.03.2022.