

EFRAG Secretariat: Didrik Thrane-Nielsen,
Marlene Geider, Sebastian Weller

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International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX March 2022]

Dear Mr Barckow,

Re: Non-current Liabilities with Covenants Proposed amendments to IAS 1

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the exposure draft proposed amendments to IAS 1, *Non-current Liabilities with Covenants*, issued by the IASB on 19 November 2021 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG supports 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 and accepts that liabilities should be classified as current or non-current based on the situation as at the end of the reporting period.

EFRAG disagrees with the proposal to require 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.

EFRAG encourages 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. Instead, EFRAG recommend to:

- (a) delete paragraph 72(C) while transferring 72C(a) to a new paragraph 72B(c); and
- (b) changing the wording in 72B(c).

EFRAG also recommends to the IASB to clarify

- (a) the requirement in paragraph 72A of IAS 1 that "substantive rights" must exist; and
- (b) the interaction of paragraph 72B(b) and paragraph 75 of IAS 1.

EFRAG is concerned that the targeted scope of the disclosure requirements may in practice be too broad and recommends to the IASB to add in paragraph 76ZA(b) that disclosures should only be made in case of significant uncertainties on whether conditions will be met. 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). EFRAG recommends to specify that only the facts and circumstances that existed at the end of the reporting period should, in line with the principles in IAS 10, be considered when forward-looking information about "whether" to comply in future is disclosed.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Sebastian Weller or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Question 1 - Classification and disclosure

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

The Board proposes to require that, for the purposes of applying paragraph 69(d) of IAS 1, specified conditions with which an entity must comply within twelve months after the reporting period have no effect on whether an entity has, at the end of the reporting period, a right to defer settlement of a liability for at least twelve months after the reporting period. Such conditions would therefore have no effect on the classification of a liability as current or non-current. Instead, when an entity classifies a liability subject to such conditions as non-current, it would be required to disclose information in the notes that enables users of financial statements to assess the risk that the liability could become repayable within twelve months, including:

(a) the conditions (including, for example, their nature and the date on which the entity must comply with them);

(b) whether the entity would have complied with the conditions based on its circumstances at the end of the reporting period; and

(c) whether and how the entity expects to comply with the conditions after the end of the reporting period.

Paragraphs BC15–BC17 and BC23–BC26 of the Basis for Conclusions explain the Board's rationale for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

EFRAG's response

Classification

- 1 EFRAG supports the IASB's efforts to address the concerns of constituents that have emerged in the context of the IFRS Interpretations Committee's December 2020 tentative agenda decision.
- 2 The proposals in this ED will improve the clarity of the classification of liabilities that have to comply with specified conditions (commonly referred to as covenants) within twelve months after the end of the reporting period.
- 3 EFRAG accepts that such liabilities should be classified based on the situation as at the end of the reporting period and is sympathetic with the reasons supporting the classification approach proposed in this ED presented in BC16.
- 4 EFRAG assesses that the concept of substantive rights as expressed in paragraph 72A of IAS 1 – which was introduced as part of the 2020 amendments – requires clarification as its implications on the guidance seems not to be fully investigated. Therefore, EFRAG recommends the IASB to add guidance and/or examples on how to apply the “substantive right” requirement in paragraph 72A, especially with regard to a clarification of the term, the interactions with paragraph 72B(b), and its consequences on forward-looking disclosures.
- 5 EFRAG acknowledges that paragraph 72B and the subparagraphs (a) and (b) of the ED provide a clear technical dividing line for specified conditions the entity must comply with on the one hand before or on the reporting period end and on the other hand after the reporting period end. Although, EFRAG has doubts about whether paragraph 72B(b) assures reflection of the economic substance of the entities rights when testing of compliance is done based on conditions shortly after the end of the reporting period.

- 6 EFRAG notes that the relationship between paragraph 72B(b) and 72C(b) of the ED is not clear: a liability with a specified condition will not be classified as current if compliance is only required within the next 12 months after the reporting period end (paragraph 72B(b)), whereas per paragraph 72C(b) the liability must be classified as current if it could become payable as a result of an “*uncertain future event*” (that may arise with the next 12 months after the reporting period end) that is unaffected by the entity’s future actions.
- 7 In addition, EFRAG has reservations on the wording ‘*unaffected by the entity’s future actions*’, as it does not help to clearly differentiate covenants in the scope of paragraph 72B(b) and 72C(b). EFRAG considers that in a number of relevant fact-patterns it will be difficult to differentiate between future events or outcomes that are, or are not, affected by the entity’s future actions. It may not always be as simple as in the case of payments related to disasters or weather conditions. EFRAG further considers it difficult to differentiate between those events or outcomes that are affected by the entity’s past or present actions as opposed to future actions.
- 8 Paragraph 72C(b) is supported by additional information given in paragraph 19 of Basis for Conclusion of the ED. The paragraph, which is not part of the main body of the standard, explains that in paragraph 72C:
- “there are no conditions with which the entity must or could comply in order to avoid settlement of a liability within twelve months after the reporting period.”*
- EFRAG considers that the clarification does not fully solve the interpretation issue.
- 9 Therefore, EFRAG recommends to not base the main explanation for differentiation in paragraph 72C(b) on the words “affected” or “unaffected”, but to delete paragraph 72C(b) and to relocate paragraph 72C(a) to a new paragraph 72B(c) with the following wording:
- (a) *“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 recommend 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.”*
- 10 EFRAG recommends to the IASB to not mention insurance liabilities as an example of a current liability. Such liabilities also cover events (cash outflows) that will arise in the longer term (above twelve months). Moreover, EFRAG has doubts about the information value of insurance liabilities classified as current as pointed out in paragraph 72C(b) as insurance liabilities are mostly accounted for as a portfolio. EFRAG also has concerns regarding the relation of the requirements for insurance liabilities under the proposals to IFRS 17 Insurance Contracts.
- 11 EFRAG recommends to the IASB to clarify the interaction of paragraph 72B(b) and paragraph 75 of IAS 1. EFRAG is aware that paragraph 75 of IAS 1 is not part of this amendment but requests the IASB to closer investigate the interaction of both paragraphs and whether their outcomes are consistent.
- 12 Paragraph 69(d) of IAS 1 and paragraph 72B and 72C of the ED focuses on the right of the entity to defer settlement. Paragraph 61 focuses on the expected timing of settlement. EFRAG proposes that the interaction of disclosures based on expectations and classification based on legal rights is considered further by the IASB. In EFRAG’s view the root cause of the problem, that the IASB is working to solve through the 2020 amendment and the current ED, is paragraph 69(d) of IAS

1. Based on the proposed amendments users will not have a clear view on the liquidity position of the entity – except if they are looking into the disclosures – therefore, while being aware that the project is a narrow scope amendment, EFRAG recommends debating the broader issue of classification covering paragraph 69 of IAS 1 in the primary financial statements project.

- 13 EFRAG proposes that the IASB should clarify that the guidance in paragraph 72B and 72C does not impact the order of liquidity if presentation by order of liquidity in paragraph 60 and 64 is applied.

Disclosures

- 14 EFRAG acknowledges that information about conditions which may affect the payment terms of outstanding liabilities is of great importance to users of financial reporting. EFRAG agrees with the direction of the proposed disclosure requirements, but has some concerns related to the targeted scope of the disclosure requirements. EFRAG expects that the proportion of liabilities subject to specified conditions will be significant, if compared with liabilities not subject to such conditions. Thus, the proportion of non-current liabilities that will be subject to the disclosure requirements in paragraph 76ZA(b) will be significant. EFRAG has a concern that a rather broad target population for the disclosure requirements leads to a higher workload by preparers and contains a risk of the disclosures being boilerplate.
- 15 Therefore, EFRAG proposes to the IASB to elaborate on the application of materiality for such disclosures, especially with regard to the significance of the impact on the entity's liquidity. Furthermore, EFRAG recommends to add in paragraph 76ZA(b) that disclosures should be made in case of significant uncertainties on whether conditions are met within twelve months after end of reporting period.

Question to EFRAG FR TEG

Some of the constituents referred to the need to incorporate the concept of probability in the proposal. Please see the proposed possible addition below:

With regard to significant uncertainties EFRAG would refer to whether it is more likely than not (or alternatively more than a remote probability) that the entity will not comply within twelve months after the reporting period. This would reduce diversity in practice and could prevent the undermining of the disclosure requirement in paragraph 76ZA(b)(iii) (“whether an entity expects to comply”).

Do EFRAG FR TEG members consider that EFRAG should include the above paragraph in the final comment letter?

- 16 EFRAG is sympathetic with the concerns mentioned in the alternative view paragraph AV5 of the ED about providing forward-looking information with respect to “how” future compliance with covenants will be achieved. For this reason, EFRAG proposes to redraft paragraph 76ZA(b)(iii) as follows:

“whether the entity expects to comply with the conditions after the end of the reporting period based on facts and circumstances at the end of the reporting period.”

EFRAG considers it not to be useful, especially in the light of the large scope, to explain the reasons why the specified conditions would be met or the means to achieve compliance in the following period. Additionally, such kind of behavioural disclosures that explain “how” something will be achieved by the entity's management are not common in IFRS standards and not appropriate as this goes beyond the role of stewardship of financial statements.

- 17 As the proposals in paragraph 76ZA(b)(iii) do not directly specify what information the entity should consider, we deem it necessary to propose to the IASB to consider only the facts and circumstances that existed at the end of the reporting period in line with IAS 10. This view is consistent with the classification under paragraph 72B(b) of IAS 1, so when the classification is based on the facts and circumstances at the end of the reporting period the disclosures follow the same principle.
- 18 Moreover, EFRAG also recommend to the IASB to further investigate the interaction of the disclosure requirement in paragraph 76ZA(b)(iii) and the requirement in 72A for right to defer to have “substance”. EFRAG has the concern that the requirement for right to have “substance” would contradict the disclosure requirement in 76ZA(b)(iii). If the entity does not expect to comply with the specified condition, should the entity then reassess whether its right to defer has “substance”? E.g., whether this should ultimately result in a current classification.
- 19 EFRAG would like to point out that the disclosure requirements could leverage information about covenants that may add to liquidity risk as disclosed under paragraph 31 et seq. of IFRS 7 (nature and extent of risks). The IASB should consider how to effectively leverage on those requirements.
- 20 To integrate the amendments into the existing standard, EFRAG recommends the IASB to insert a new disclosure requirement in paragraph 76 (new subletter) “a breach of a condition on a liability classified as non-current (see paragraph 72B(b))”.

Question 2 - Presentation

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

The Board proposes to require an entity to present separately, in its statement of financial position, 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.

Paragraphs BC21–BC22 of the Basis for Conclusions explain the Board’s rationale for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, do you agree with either alternative considered by the Board (see paragraph BC22)? Please explain what you suggest instead and why.

EFRAG’s response

- 21 EFRAG disagrees with the requirement to separately present on the face of the balance sheet 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 (paragraph 72B(b) of IAS 1). EFRAG instead recommends to require to disclose this information in the notes.
- 22 The disagreement is based on the proposal’s contradiction with the principle-based nature of IFRS Standards. Because of the principle-based nature rules should only be set out in rare cases. We concur with the statement under paragraph AV3 of the ED that the proposed presentation does not represent such a compelling case. Moreover, to present information entities should prioritize that most relevant information to users will be presented in the financial statements and that other information will be presented in the notes. Given this principle of information grading as explained in paragraph AV3 of the ED EFRAG suggests, also referring to the large population of liabilities concerned, to not contradict the principle by introducing a new category that probably includes almost all liabilities.

- 23 As stated before, EFRAG has reservations about the scope of liabilities with right to defer settlement subject to compliance with specified conditions. EFRAG considers that in practice, also having in mind the potential wider scope of the proposals (e.g., for provisions and other liabilities with specified conditions), it will not result in more useful information, as too many liabilities will be captured. There is no definition of what constitutes a specified condition, so consequently there is a risk that the entire population of liabilities arising from arrangements might only be presented under a different heading (relabelled). A separate presentation of a small group of non-current liabilities that would not be subject to specific conditions would not be useful for investors, and furthermore create a risk of obscuring relevant information.
- 24 Finally, EFRAG concludes that the implementation of a third category of classification on the liability side as a consequence of the ED's proposals would undermine the differentiation between non-current and current liabilities as required by paragraph 60 of IAS 1 and conflict with the alternative presentation using the "order of liquidity".

Question 3 – Other aspects of the proposal

Question 3 — Other aspects of the proposals

The Board proposes to:

- (a) clarify circumstances in which an entity does not have a right to defer settlement of a liability for at least twelve months after the reporting period for the purposes of applying paragraph 69(d) of IAS 1 (paragraph 72C);
- (b) require an entity to apply the amendments retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, with earlier application permitted (paragraph 139V); and
- (c) defer the effective date of the amendments to IAS 1, Classification of Liabilities as Current or Non-current, to annual reporting periods beginning on or after a date to be decided after exposure, but no earlier than 1 January 2024 (paragraph 139U).

Paragraphs BC18–BC20 and BC30–BC32 of the Basis for Conclusions explain the Board's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

EFRAG's response

- 25 EFRAG supports the IASB efforts to improve the guidance with regard to the current and non-current classification of liabilities with specified conditions. Nevertheless, EFRAG – as expressed in paragraphs 6 - 8 of this [Draft] Final Comment Letter – finds it challenging to differentiate between specified conditions in the scope of paragraph 72B(b) and 72C(b).
- 26 EFRAG supports the proposed retrospective application as suggested in the amendment of IAS 1 with earlier application permitted. EFRAG considers classifying a liability as current or non-current should happen on a same basis for the current and the prior year, this supports comparability, and enhances usefulness of information. EFRAG agrees with the IASB conclusion in BC30(b) of the ED that this requirement will not lead to significant disadvantages for entities.
- 27 EFRAG recommends to the IASB to clarify in the standard that both amendments (the 2020 amendment and the 2021 ED) shall be applied together as a package and to align the effective dates for the two amendments.

- 28 EFRAG supports the proposed effective date of the amendment to IAS 1 to be for annual reporting periods beginning on or after the 1 January 2024 provided that the IASB will publish the final standard in 2022.