

Draft Comment Letter

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Comments should be submitted by 9 March 2022.

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. As a possible way forward, the IASB could consider to clarify that:

- (a) obligations to repay as a consequence of a discrete event occurring after the end of the reporting period do not affect the presentation at the end of the reporting period and
- (b) items such as financial guarantees would be classified as current, as the underlying contractual agreements do not provide a fixed payment schedule after 12 months.

EFRAG is concerned that the targeted scope of the disclosure requirements may be in practice too broad and suggests 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 suggests to add in paragraph 76ZA(b) that disclosures should be made in case of significant uncertainties on whether conditions are 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).

[Some EFRAG members questioned the usefulness of the disclosure and EFRAG is seeking specific input by constituents on 76ZA (b)].

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

Notes to constituents – Summary of proposals in the ED

Question 1 - Classification and disclosure

- 1 The current paragraph 69(d) of IAS 1 requires an entity to classify a liability as current when it does not have the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period.
- 2 In January 2020, the IASB issued amendments to IAS 1 that clarified aspects of how entities classify liabilities as current or non-current; in particular, 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 (often referred to as 'covenants') within twelve months after the reporting period.
- 3 In response to questions from stakeholders, the IFRS Interpretations Committee published a tentative agenda decision explaining how to apply the 2020 amendments to particular fact patterns. The tentative agenda decision explained that an entity does not have the right to defer settlement of a liability—and thus classifies the liability as current—when the entity would not have complied with specified conditions based on its circumstances at the end of the reporting period, even if compliance with such conditions were required only within twelve months after the reporting period. Respondents to the tentative agenda decision raised concerns about the outcomes and potential consequences of the 2020 amendments in some situations. The Committee reported this feedback to the Board, highlighting new information that the Board had not considered when developing the amendments. The IASB decided to open a project and issue (with this ED) a new amendment to IAS 1.
- 4 The ED propose to amend IAS 1 and 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.
- 5 In particular, paragraph 72B of the ED describes that in some situations an entity's right to defer settlement of a liability for at least twelve months after the reporting period may be subject to the entity complying with specified conditions. The ED states that, considering the requirement in paragraph 69(d) of IAS 1, a specified condition:
 - (a) affects the existence of the right to defer the settlement at the end of the reporting period, if the entity is required to comply with the condition on or before the end of the reporting period, also in cases where the assessment of compliance is made after the reporting period (paragraph 72B(a) of the ED).
 - (b) does not affect the existence of the right to defer the settlement at the end of the reporting period if the entity is required to comply with the condition only within twelve months after the reporting period (paragraph 72B(b) of the ED).
- 6 The ED paragraph 76ZA(b) states that when an entity classifies liabilities subject to the conditions described in paragraph 72B(b) as non-current, the entity shall disclose information in the notes that enables users of financial statements to assess the risk that the liability could become repayable within twelve months.
- 7 As per paragraph 76ZA(b) of the ED the disclosure requirements include:
 - (a) the conditions with which the entity is required to comply (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.
- 8 IAS 1 is applicable to all liabilities. Thus, in addition to financial liabilities within the scope of IFRS 9 the classification as current or non-current will also apply to liabilities within the scope of other standards such as IFRS 2, IFRS 15, IFRS 16, IFRS 17, IAS 12, IAS 19, IAS 26, and IAS 37.

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

- 9 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.
- 10 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.
- 11 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.
- 12 EFRAG acknowledges that paragraph 72B and the subparagraphs (a) and (b) of the ED provide a conventional dividing line for specified condition 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. Nevertheless, EFRAG questions whether paragraph 72B(b) allows to capture the economic substance of the entities rights when testing of compliance is done based on conditions shortly after the end of the reporting period.

- 13 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.
- 14 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 there is a risk of different interpretation, as it will be difficult to differentiate between future events or outcomes that are, or are not, affected by the entity’s future actions. For examples EFRAG Secretariat refers to Annex 1 to this letter. 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.
- 15 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. Therefore, EFRAG suggests to not base the main explanation for differentiation in paragraph 72C(b) on the words “affected” or “unaffected”, but instead to clarify that
- (a) obligations to repay as a consequence of a discrete event occurring after the end of the reporting period do not affect the presentation at the end of the reporting period and
 - (b) that items such as financial guarantees would be classified as current, as the underlying contractual agreement do not provide a fixed payment schedule after 12 months.
- 16 EFRAG has reservations with regard to the example of insurance liabilities, which seems to imply that financial liabilities are to be classified as current in all circumstances, as depending on the specific characteristics of the contract the underlying insured event may arise after 12 months. Moreover, EFRAG questions the information value of insurance liabilities classified as current as pointed out in paragraph 72C(b) and the interaction between these requirements and IFRS 17 *Insurance Contracts*.
- 17 Furthermore, EFRAG proposes to relocate paragraph 72C(b) to paragraph 72B, consequently 72C would concentrate on the statement made in subparagraph (a).
- 18 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 paragraph 61 and paragraph 69(d) is considered further by the IASB. 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.
- 19 EFRAG suggest the IASB to clarify the interaction between paragraph 72B(b) and paragraph 75 for situations where at the end of the reporting period an entity has received a waiver and is in a grace period ending within twelve months.

Question to Constituents

- 20 Do Constituents agree with issues identified by EFRAG?
- 21 Do Constituents agree with the EFRAG proposed alternative wording for 72C(b) proposed in paragraph 15 above, as a way to address the risk of possible different interpretations for the term '*unaffected by the entity's future actions*'?
- 22 Do Constituents agree that covenants to be complied with based on conditions (even shortly) after the end of the reporting period should not cause presentation as current? Does this reflect the economic substance of covenants?
- 23 IAS 1 paragraph 69(d) focuses on right to defer settlement as opposed to assumptions about timing of cashflows as used in the measurement of the liabilities. Some stakeholders observe that this may lead to misalignments between presentation and measurement. They note that this ED is a narrow scope amendment to IAS 1, it gives some clarification on presentation but does not solve the driver for the misalignment. At the same time, other stakeholders note that solving the concerns of constituents that have emerged in the context of the IFRS Interpretations Committee's December 2020 tentative agenda decision should be the priority of this IASB project, therefore they accept the proposals in this ED as a solution. Do Constituents agree with EFRAG position to support the decision to clarify but not amend the principle in paragraph 69(d) of IAS 1?
- 24 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. Nevertheless, EFRAG agrees to the scope, but 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.
- 25 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 suggests to add in paragraph 76ZA(b) that disclosures should be made in case of significant uncertainties on whether conditions are met.
- 26 EFRAG is sympathetic with the concerns mentioned in the alternative view paragraph AV5 of the ED about providing forward-looking information with respect to future compliance with covenants. 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 known up to the date of issuance of the financial statements."*
- 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.
- 27 EFRAG recommends the IASB to clarify whether disclosures would be required in situations where the entity presents the balance sheet in order of liquidity.
- 28 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.

- 29 Finally, some EFRAG members questioned the usefulness of the disclosure required by 76ZA (b), as:
- (a) the disclosure requirements should follow a more principles-based approach, i.e. focusing on liquidity risk instead of on single liability becoming payable within 12 months. These members concur with the view above that the IASB should leverage on the disclosure requirements that already exist in IAS 1 (going concern) and IFRS 7 (liquidity risk);
 - (b) the information proposed in 76ZA (b) has already informed the classification on balance sheet (including the expectation to fulfil the covenant).

Question to Constituents

- 30 What are the Constituent's views on additional disclosure requirements in IAS 1 with regard to specified conditions? Do you think that IFRS 7 already requires the preparer to make such disclosures? If yes, do you think that there is a problem to enforce possible disclosures under IFRS 7? If not, do you consider that those disclosures would be better off as part of IFRS 7?
- 31 Two IASB Board members voted against the publication of the ED. Paragraph AV5 of the ED illustrates that they (in addition to being contrary to the separate presentation proposal) disagree with the requirement proposed in paragraph 76ZA(b)(iii) to disclose whether and how an entity expects to comply with conditions after the reporting date. They disagree because, in their view, entities should not be required to provide forward-looking information with respect to future compliance with covenants.
- (a) Do Constituents have particular concerns related to the provision on such forward-looking information? Please explain.
 - (b) Do Constituents agree to change 76ZA(b)(iii) as proposed by EFRAG in paragraph 27 above?
 - (c) Some EFRAG members questioned the usefulness of the disclosure required by 76ZA (b). Do constituents agree with the usefulness of such disclosure?
 - (d) Do Constituents consider that the proposed disclosures are needed in cases where the company expects to comply with the covenant after the reporting year end?

Notes to constituents – Summary of proposals in the ED

Question 2 - Presentation

- 32 The ED paragraph 76ZA(a) requires that when an entity classifies liabilities subject to the conditions described in paragraph 72B(b) as non-current, the entity shall present such liabilities separately in its statement of financial position. It is also required that the entity shall use a description that indicates that the non-current classification is subject to compliance with conditions within twelve months after the reporting period.
- 33 Two IASB Board members disagreed with this proposal, as they consider specific presentation requirements as contrary to the principle-based nature of IFRS Standards.

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

- 34 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. EFRAG instead recommends to require to disclose this information in the notes.
- 35 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.
- 36 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.
- 37 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 to Constituents

- 38 Do Constituents agree with the position of not recommending a separate presentation, irrespective of the scope of the separate presentation?

Notes to constituents – Summary of proposals in the ED

Question 3 – Other aspects of the proposal

- 39 The ED refers in paragraph 72A to an entity's right to defer settlement of a liability for at least twelve months after the reporting period must have substance and, as illustrated in paragraphs 72B–75, must exist at the end of the reporting period.
- 40 Under the ED's paragraph 72B(a) a right to defer settlement of a liability for at least twelve months after the reporting period may be subject to specified conditions, which could affect whether the right exists at the end of the reporting period if the compliance would be required on or before the end of the reporting period, even in case the compliance is tested shortly after the reporting period end.
- 41 According to the ED and paragraph 72C a right to defer settlement of a liability for at least twelve months after the reporting end would also not exist, if the liability could become repayable within twelve months after the reporting period:
- (a) at the discretion of the counterparty or a third party (loan is callable by the lender at any time without cause); or
 - (b) if an uncertain future event or outcome occurs (or does not occur) and its occurrence (or non-occurrence) is unaffected by the entity's future actions—for example, when the liability is a financial guarantee or insurance contract liability. In such situations, the right to defer settlement is not subject to a condition with which the entity must comply as described in paragraph 72B.
- 42 Furthermore, the ED's paragraph 139V requires a retrospective application (IAS 8) of the amendments. The annual reporting periods where the amendments will first be applied is still to be decided on, but the ED indicates that the earliest date would be the 1 January 2024. An earlier application would be permitted.

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

- 43 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 13-15 of this Draft Comment Letter – finds it challenging to differentiate between specified conditions in the scope of paragraph 72B(b) and 72C(b).

- 44 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, supports comparability, and 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.
- 45 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.

Question to Constituents

- 46 Do Constituents agree with the EFRAG's comments on the other topics?
- 47 Do Constituents would like to raise additional questions or issues that should be highlighted by EFRAG?

Annex 1 - Notes to constituents

48 This annex has been prepared by EFRAG Secretariat to support constituents to get an understanding of how the definition of 'specified conditions' in the ED would work in practice when applied to some frequently used covenants. The list of examples is not exhaustive.

Examples of conditions/covenants

49 The list below present covenants commonly used for which there is a risk of different interpretation when assessing whether the covenant is 'unaffected' by the entity's future actions.

- Change of control
- Change of management
- IPO (the liability may become subject to repayment on an IPO or if an IPO does not occur before a specified date)
- De-listing event
- Accounting key ratios / financial covenants
- Default / cross default
- Cross default in subsidiaries
- Cross default in group entity not controlled by the entity
- Expected default
- Loss of control over pledged asset
- Subject of sanctions
- Change of law
- Dividend control
- ESG condition
- Weather condition
- Commodity conditions

50 Paragraph 69(d) including paragraph 72B and 72C applies to all liabilities (which among others include liabilities in IFRS 2, IFRS 9, IFRS 15, IFRS 16, IFRS 17, IAS 12, IAS 19 IAS 26, and IAS 37)

Annex 2 – Summary of responses

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

EFRAG supports this ED as it addresses the concerns of constituents.

EFRAG suggests to not base the main explanation for differentiation in paragraph 72C(b) on the words “unaffected”, but instead to clarify that (a) payments as a consequence of a discrete event occurred after the balance sheet date do not affect the classification; and (b) items such as financial guarantees would be classified as current.

EFRAG proposes that the interaction of paragraph 61 and paragraph 69(d) of IAS 1 is considered further by the IASB. 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.

EFRAG has a concern that the rather broad target population for the disclosure requirements contains a risk of the disclosures being boilerplate and 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.

EFRAG suggests to add in paragraph 76ZA(b) that disclosures should be made in case of significant uncertainties on whether conditions are met.

EFRAG also proposes to redraft paragraph 76ZA(b)(iii).

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

EFRAG disagrees with the separate presentation on the face of the balance sheet of the liabilities classified as non-current for which the entity’s right to defer settlement is subject to compliance with specified conditions within twelve months after the reporting period.

Question 3—Other aspects of the proposals

EFRAG supports the other aspects of the ED.