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Non-Current Liabilities with Covenants Cover Note

Objective

- 1 The purpose of the session is to update EFRAG FR TEG-CFSS on the feedback received from outreach on EFRAG draft comment letter to the IASB's exposure draft ED/2021/09 Non-Current Liabilities with Covenants. The IASB published the exposure draft ('the ED') in November 2021 with a comment deadline on 21 March 2022.
- 2 The feedback received, as integrated into the EFRAG final comment letter to the IASB, will be presented at the Accounting Standards Advisory Forum ('ASAF') meeting at the end of March 2022. Agenda paper 09-02 includes the ASAF agenda paper on Non-Current Liabilities with Covenants for background only.

Background of the IASB project

- 3 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.
- 4 In a submission to the IFRS Interpretations Committee questions were raised about the application of the proposals 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.
- 5 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.

Summary of the IASB's proposals on the project

- 6 In the Exposure Draft the IASB:
 - (a) has introduced (in the previous amendment 2020) the notion of "substantive rights" in 72A that will have to exist with regard to the "right to defer settlement";

- (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 12-month period after the end of the reporting period;
- (c) clarifies that
 - (i) certain liabilities with specified conditions to be complied with at the reporting period end but tested after the reporting period end 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 can not 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) proposes 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) provides 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.

EFRAG FR TEG-CFSS discussion in February

- 7 On 17 February 2022, EFRAG FR TEG-CFSS discussed the IASB's proposals on Non-Current Liabilities with Covenants and the EFRAG's tentative position included in its draft comment letter on the project. Members made the following comments:
- (a) Most members agreed that no separate presentation should be required.
 - (b) Disclosures
 - (i) Members were split with regard to whether the scope of disclosures should be restricted to a subset of liabilities under paragraph 72B(b).
 - (ii) One CFSS member stated that they were undecided about the forward-looking information whereas another CFSS noted that such kind of information would already be required by other standards (e.g., disclosures on liquidity risk or going concern).
 - (iii) Most CFSS member noted that they would regard forward-looking information either as a problem in the context of local laws and regulation or as information that would potentially be boilerplate.
 - (iv) Most CFSS member noted that the forward-looking information should consider events up to the date of the publication date while another CFSS member had split views about this requirement due to the general guidance in IAS 10 for events after the balance sheet date.
 - (c) Most CFSS members confirmed that the differentiation between paragraph 72B(b) and 72C(b) would lack clarity.
 - (i) One CFSS member also noted that the alternative proposal in EFRAG's DCL would also lead to question with regard to the definition set up in paragraph 15 ("discrete event").

- (ii) Several members agreed that the main reason for the problem underlying the classification was based on the guidance given in paragraph 69(d) of IAS 1. A member proposed to state in 69(d) that the classification should be based on the facts and circumstances as of the reporting period end not looking into the future.
- (iii) Members did not support the alignment of classification and measurement as part of this narrow scope amendment but suggested to highlight that this could be part of the broader primary financial statement project.
- (d) One member highlighted that a current classification of liabilities with covenants based on the guidance in the proposals could further trigger other breaches of covenants (e.g., by cross default) and therefore have severe economic consequences. To classify as current a liability based on the existence of a change of control clause would not be appropriate.

EFRAG Academic Panel discussion in March

- 8 On 4 March 2022, EFRAG Academic Panel discussed the IASB's proposals on Non-Current Liabilities with Covenants and the EFRAG's tentative position included in its draft comment letter on the project. Members made the following comments:
- (a) Almost all members (except for one) agreed with EFRAG's preliminary position that separate presentation of non-current liabilities subject to conditions within 12-months should not be required.
 - (b) About disclosures:
 - (i) Members noted that financial information is going to be used digitally, therefore an information overload (due to increased volume of disclosures) was not expected.
 - (ii) Members concurred on the importance of having forward looking information about the risk of a breach of a covenant.
 - (c) About classification:
 - (i) Few members pointed out that the guidance for classification does not lead to useful information for users as it does not give insights about the probability that repayment would be required within 12-month after the reporting period end. Members suggested to incorporate a probability criterion in the classification model (similar to recognition and measurement).
 - (ii) Members noted that this was a compromise solution– it was not a conceptually based solution. The IASB could add it to its agenda to have a conceptual way of doing it.
 - (iii) Members assessed inconsistencies with regard to paragraph 72B(b) and paragraph 75 of IAS 1 which lead to the outcome that a rules based solution/approach is not suitable in all circumstances. Member also struggled with the wording in paragraph 75 of IAS 1.
 - (d) Members also suggested to limit the requirement to liabilities in the scope of IFRS 7.
 - (e) One member made a remark that para. 45 of EFRAG's DCL refers to the missing principle-based solution. However, distinguishing between current and non-current would already be a rules-based approach, so it would not be useful to highlight that there is no principles-based solution for an overarching problem that is rules based. Therefore, a review of the paragraph was requested.

Feedback from users (EFRAG User Panel) in February

- 9 In February 2022, EFRAG also conducted outreach on the proposals of the ED on Non-Current liabilities with Covenants with users of financial statements. Users made the following comments:
- (a) Most users especially from credit rating agencies agreed with the proposals to offer more information on specified conditions and also agreed with getting forward-looking information. The entities performance with regard to the covenant should be clearly explained.
 - (b) Publishing forward-looking information should not be a problem as entities would already use such information in other publications. Consequently, it would be necessary to know whether a waiver or a period of grace was granted by the lender.
 - (c) One user expected that a liability is to be classified as current when it liability would have to be repaid within 12-month after the reporting period.
 - (d) Users would find it particularly useful to have audited information as management normally provides unaudited information about their covenants/specified conditions. One user referred to problem with forward-looking information in the US. The user also noted that a restriction of the scope of the disclosures to certain liabilities would not be needed from their point of view. Normally less information would be a problem for user, but more is better except for potential boilerplate information which would never be useful.
 - (e) A separate presentation was not required but could be a signal to take a look in the note disclosures but this would probably make more sense when the population of liabilities with covenants would be small.
 - (f) The classification requirement of the proposals would not be important for users because they would require information that shows the economic substance (how far is the entity from breaching or how much liquidity risk exists), so information from the notes would take precedence over information based on separate presentation (e.g., when the covenant is probably breached but the liability is still being classified as non-current or when a liability is classified current as a result of a change of control clause). Even if a breach would occur, the liability would still be deemed non-current in the analysis if the entity was sure to receive a waiver by the lender.

Messages from other outreach activities

- 10 EFRAG did additional outreach sessions where the ED/2021/09 was discussed. The general feedback is as follows:
- (a) Separate presentation should not be required.
 - (b) Forward-looking disclosure requirements are supported and will not create issues. Nevertheless, EFRAG's position was supported to not require disclosures on how an entity will comply with the requirements.
 - (c) Classification will require additional clarification due to the wording in paragraph 72C(b).
 - (d) The interaction of paragraph 72A and 74/75 of IAS 1 should be further explained. Also, the substance requirement in paragraph 72A – introduced with the 2020 amendments – should be further explained.
 - (e) The two amendments (2020 and 2021) should be applied simultaneously with no option to early application just for the 2020 amendments.

Question for EFRAG CFSS

Background ASAF questions

The IASB Staff Agenda Paper prepared for ASAF asks the following questions (which overlap with the questions the IASB is asking in the ED): Do you support the IASB's proposals on:

- a) Classification of liabilities as current or non-current—only covenants with which the company must comply on or before the reporting date affect classification as current or noncurrent?
- b) Separate presentation—companies would present separately on their balance sheet noncurrent liabilities subject to compliance with covenants within 12 months after the reporting date?
- c) Disclosure of information about covenants—companies would disclose information that enables investors to assess the risk that the liability could become repayable within twelve months, including:
 - i. the covenants (their nature and date on which the company must comply with them)
 - ii. whether the company would have complied with the covenants at the reporting date; and
 - iii. whether and how the company expects to comply with the covenants in the future?

11 Do EFRAG CFSS members have additional remarks at this stage?

Agenda Papers

- 12 In addition to this cover note, agenda paper 04.02 – ASAF Agenda Paper 2 *Non-Current Liabilities with Covenants* – has been provided for the session.