EFRAG's Letter to the European Commission Regarding Endorsement of Amendments to IAS 1: Non-current Liabilities with Covenants, Amendments to IAS 1: Classification of Liabilities as Current or Non-current and Amendment to IAS 1: Classification of Liabilities as Current or Non-current - Deferral of Effective Date

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European Commission
1049 Brussels

30 March 2023

Dear Mr John Berrigan

Endorsement of Amendments to IAS 1: Non-current Liabilities with Covenants, Endorsement of Amendments to IAS 1: Classification of Liabilities as Current or Non-current; and Endorsement of Amendment to IAS 1: Classification of Liabilities as Current or Non-current - Deferral of Effective Date

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the Amendments to IAS 1: *Non-current Liabilities with Covenants*, Amendments to IAS 1: *Classification of Liabilities as Current or Non-current* and Amendment to IAS 1: *Classification of Liabilities as Current or Non-current - Deferral of Effective Date* (together "the Amendments"). These were issued by the IASB on 31 October 2022, 23 January 2020, and 15 July 2020 respectively. The Exposure Drafts of the Amendments were issued on 19 November 2021, 10 February 2015, and 4 May 2020 respectively. EFRAG provided its comment letters on these Exposure Drafts on 29 March 2022, 22 June 2015, and 3 June 2020 respectively). A description of the Amendments is included in Appendix 1 to this letter.

The objective of the Amendments is to clarify the principles in IAS 1 *Presentation of Financial Statements* for classification of liabilities as either current or non-current. The Amendments:

- clarify the notion of settlement of the liability;
- clarify that management intent does not affect current or non-current classification;
- clarify that options by the counterparty that could result in settlement by the transfer of the entity's own equity instruments do not affect current or non-current classification;
- specify how an entity classifies a liability arising from a loan arrangement with covenants as current or non-current; and

- regulate the disclosures to be provided when an entity has loan arrangements with covenants that could require the loan arrangement to become payable within twelve months after the reporting period.

The Amendments shall be applied retrospectively for annual periods beginning on or after January 2024, with earlier application permitted. If entities apply the Amendments earlier, they shall disclose that fact.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments (considered as a package) would meet the technical criteria for endorsement, in other words, whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that the Amendments when considered in totality, meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and raise no issues regarding prudent accounting.

EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments, when considered as a package, would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

Our advice to the European Commission

As explained above, we have concluded that the Amendments as a package meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Wolf Klinz
Chair of the EFRAG Financial Reporting Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 Before issuing its Exposure Draft ED/2015/1 Classification of Liabilities, the IASB was asked how an unconditional right to defer settlement (specified in paragraph 69(d) of IAS 1) related to the discretion to refinance or roll over an obligation (specified in paragraph 73 of IAS 1).

2 In January 2020, the IASB issued *Classification of Liabilities as Current or Non-current* (the "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.

3 In July 2020, due to the Covid pandemic the IASB issued *Classification of Liabilities as Current or Non-current – Deferral of Effective Date* which deferred the application date of the 2020 amendments to annual reporting periods starting on or after 1 January 2023.

4 In December 2020, after informal feedback and enquiries received from stakeholders, the IFRS Interpretations Committee issued a tentative agenda decision clarifying how the 2020 amendments where to be applied for liabilities with covenants 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 IFRS Interpretation Committee reported this feedback to the IASB, highlighting new information (e.g. the seasonality issue) that the IASB had not considered when developing the 2020 amendments.

5 In October 2022, after having issued its Exposure Draft ED/2021/9 *Non-current Liabilities with Covenants* in November 2021, the IASB issued Amendments to IAS 1: *Non-current Liabilities with Covenants* which amended parts of the 2020 amendments with the aim to improve the information an entity provides when it has the right to defer settlement of a liability arising from a loan arrangement for at least twelve months subject to compliance with covenants, in addition to addressing concerns about the classification of such liabilities as current or non-current.

The issue and how it has been addressed

6 IAS 1 (as currently endorsed by the EU) requires an entity to classify a liability as current unless, among other things, the entity has an unconditional right to defer settlement of the liability for at least twelve months. Sometimes preparers of financial statements find it difficult to interpret this requirement (including the meaning of settlement and unconditional right). As a result, entities may classify similar liabilities differently, making it hard for users to understand and compare the financial positions of different entities.

7 When a liability may be discharged through the delivery of goods, services or equity instruments instead of transfer to the counterparty of cash, the notion of settlement may be unclear.

8 In addition, when an entity has issued liabilities where the right to defer repayment of the liability is dependent upon the entity staying compliant with conditions at the end of the reporting period and or during one or more points in time within twelve months after the reporting period, it may currently not be clear whether the entity has an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

9 The Amendments provide enhanced clarity relating to the issue of settlement by adding new guidance in IAS 1. The Amendments provide enhanced guidance on the interpretation of right to defer by amending existing requirements and adding guidance in IAS 1. The Amendments also provide enhanced information for users by requiring disclosures about the existing covenants and facts and circumstances, if any that indicate the entity may have difficulty complying with covenants.

What has changed?

10 Applying the Amendments an entity shall:

(a) classify a liability as current, when one or more of the criteria in paragraph 69(a) to (c) of IAS 1 is met or, 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 (see paragraph 69(d) of IAS 1);

(b) classify a liability as current or non-current unaffected by management's intent or expectations about whether the entity will exercise its right to defer settlement (guidance in new paragraphs 75A of IAS 1);

(c) apply enhanced guidance on the notion of settlement (guidance in new paragraphs 76A and 76B of IAS 1);

(d) apply new guidance in paragraphs 72A and 72B of IAS 1, partly amended guidance in paragraphs 73 and 74 of IAS 1 and the guidance in paragraph 75 of IAS 1 when considering whether it has the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period. A short description of the content of the new and amended requirements is that an entity considers the covenant in a loan arrangement if the entity is required to comply with the covenant on or before the end of the reporting period, and does not consider the covenant in a loan arrangement if the entity is only required to comply with the covenant based on facts and circumstances after the reporting period;

(e) provide certain disclosures when it has classified a liability arising from a loan arrangement as non-current and the right is subject to the entity complying with covenants within twelve months after the reporting period (requirements in new paragraph 76ZA of IAS 1);

(f) apply enhanced guidance (in amended paragraph 76 of IAS 1) on disclosures in case of non-adjusting events in accordance with IAS 10 Events after the reporting period.

When do the Amendments become effective?

11 The Amendments are effective for annual reporting periods beginning on or after 1 January 2024 with earlier application permitted. If an entity decides to apply early any parts of the Amendments, then the entity has to disclose that fact and has to apply all of the Amendments from the same date.

12 An entity applies the Amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

EFRAG
Financial reporting

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

3 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council Directives without implying a strict conformity with each and every provision of this Directive'* (Recital 9 of the IAS Regulation).

4 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

5 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

6 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether they meet all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS Standards and whether all necessary disclosures are required.

7 In providing its assessment on whether the Amendments result in relevant, reliable, understandable and comparable information, EFRAG has considered all the requirements of the Amendments. EFRAG has, however, focused its

assessment on the requirements it considered most significant in relation to each of the criteria.

Relevance

8 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

9 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or, whether it would result in the omission of relevant information.

10 EFRAG notes that liquidity ratios are widely used in analysing financial statements, therefore the classification between current and non-current is important. As the Amendments provide more guidance on what to consider and how to make the distinction between the current and non-current liabilities, the classification is assessed to enhance consistent application, comparability between entities and thus relevance.

11 EFRAG notes that classification alone may not be sufficient to provide relevant information and that supporting disclosures may be necessary to achieve the target of relevant information.

12 EFRAG notes that the disclosure requirements introduced by the Amendments provide information that is relevant for users of financial statements to assess liquidity risks. The requirement to disclose facts and circumstances that indicate the entity may have difficulties in complying with covenants reduces the EFRAG concern related to requiring preparers to provide forward-looking information.

Reliability

13 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

14 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

15 EFRAG considers that the Amendments by clarifying the basis for assessing whether a right exists at the end of the reporting period based on facts and circumstances known at the end of the reporting period, as well as the notion of settlement, will provide reliable classification of liabilities as current or non-current. EFRAG considers that the Amendments enhance reliability as they simplify the task of preparers in providing the current or non-current classification in a manner that is free from material errors and biases, portrays a faithful representation, and is based on a complete assessment of facts and circumstances.

16 The disclosure requirements build on observable facts regarding the loan arrangements and the entity's present facts and assessments. As such the information is considered to be reliable.

17 EFRAG's overall assessment is that the Amendments would result in the provision of reliable information and therefore satisfy the reliability criterion.

Comparability

18 The notion of comparability requires that like items and events are accounted for in a consistent way over time and by different entities, and that unlike items and events should be accounted for differently.

19 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

20 EFRAG acknowledges that without the Amendments preparers of financial statements sometimes may interpret differently the requirement of having an 'unconditional right to defer settlement of the liability for at least twelve months', as well as the notion of settlement. This resulted in entities classifying similar liabilities differently, making it hard for investors to understand and compare the financial positions of different entities.

21 Although there may still be uncertainties related to complex fact patterns including layers of conditions and understanding of rights having substance, the change of wording from does not have an 'unconditional right to defer settlement' to 'the right at the end of the reporting period to defer settlement' together with the added guidance in paragraphs 72A and 72B of IAS 1 is expected to increase comparability. The clarification of the term settlement will leave less space for interpretation and will hence Increase comparability.

22 Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

23 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

24 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

25 As a result, EFRAG believes that the main additional issue it needs to consider in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information provided will be unduly complex to understand.

26 EFRAG observes that the additional disclosure requirements relating to existing covenants, and facts and circumstances indicating the relevance of the existing covenants, is expected to increase the understandability of the presentation of liabilities as current or non-current. These disclosures usefully complement the liquidity disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*.

27 In EFRAG's view, the Amendments do not introduce any new complexity that may impair understandability. Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

28 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in

recognition such that assets or income are not overstated, and liabilities or expenses are not understated.

29 Based on the Amendments it is possible that more liabilities arising from loan arrangements subject to covenants may be classified as non-current than before the Amendments, however, given the new disclosure requirements, and the fact that the classification will be based on objective facts at the end of the reporting period and not uncertain assessments of future outcome, it is our assessment that this does not result in prudence issues. Considering prudence in isolation, EFRAG notes that the 2020 amendments might have resulted in more liabilities being classified as current than what will be the case after the endorsement of the Amendments, however it is the clear assessment of EFRAG that the Amendments overall achieve a better balance in terms of relevance of the outcomes.

30 EFRAG has concluded that the Amendments raise no issues in relation to prudence as defined above.

True and fair view principle

31 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

32 EFRAG has assessed that the Amendments do not create any negative interactions with other IFRS Standards and are designed to enhance the consistent application of existing requirements of IAS 1. Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

33 EFRAG has also concluded that the appropriate disclosures that are necessary to provide a complete and reliable depiction of an entity's liabilities in the financial position are required in IAS 1.

34 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

35 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) the costs and benefits associated with the Amendments; and

(c) whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are designed to clarify specific aspects of the guidance on how to classify liabilities with covenants as current or non-current. Improved and clarified guidance together with the increased disclosures is expected to improve the quality of financial reporting.

4 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's analysis of the costs and benefits of the Amendments

5 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, as they are narrow in scope, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

Cost for preparers

6 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

7 The Amendments should be applied retrospectively. The Amendments clarify the existing, requirements for classification; however, they may result in changes in accounting policies in some cases. Therefore, some entities may already be applying IAS 1 in a way that is identical or very similar to that required by the Amendments, and for those entities it is likely that there will be little if any incremental cost involved related to presentation.

8 The increased disclosure requirements are likely to initiate set up cost when the financial reporting system must gather and update data on covenants in loan

arrangements. Although the existence of covenants is widespread the rate of change is expected to be limited for entities where the focus on satisfying loan covenants is not an area of management focus. For entities where focus on satisfying loan covenants is an area of management focus the access to this date is expected to be of limited extra cost as the data is already expected to be in the management reporting.

9 Overall, EFRAG's assessment is that the Amendments are likely to result in acceptable one-off cost and insignificant ongoing costs for preparers.

Costs for users

10 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

11 The Amendments aim to promote consistency in applying the requirements by helping entities determine whether, in the statement of financial position, debt and other liabilities with an uncertain settlement date should be classified as current (due or potentially due to be settled within one year) or non-current.

12 Overall, EFRAG's assessment is that the implementation of the Amendments will not result in increased costs to users; that is, it is likely to be largely cost neutral.

Benefits for preparers and users

13 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

14 Preparers are likely to benefit from the Amendments as they provide further guidance in an area where there has been divergence in practice. Users are likely to benefit from the increased comparability provided by the Amendments as well as the information provided by the increased disclosures.

15 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments, as the information resulting from them will increase comparability between entities and therefore will enhance their analysis.

Conclusion on the costs and benefits of the Amendments

16 EFRAG's overall assessment is that the benefits of enhanced consistency of application, increased comparability, and increased disclosures are likely to outweigh costs associated with the implementation of the requirement.

Conclusion

17 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

18 EFRAG has not identified any adverse effect the Amendments would have on the European economy, including financial stability and economic growth.

19 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.

20 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.