

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

Non-Current Liabilities with Covenants Cover Note

Objective

- 1 The objective of the session is to update EFRAG FR TEG on the latest developments of the project, especially the papers prepared for, and decisions taken at the IASB Board meeting that took place on June 20, 2022.

Structure

- 2 This cover note is structured as follows
 - (a) Paragraph 3 to 4 gives a short recap of the [ED](#) proposals and the position of EFRAG in the [CL](#)
 - (b) Paragraph 5 to 13 provides a summary of the IASB Staff papers to the June IASB Board meeting.
 - (c) Paragraph 14 to 22 provides a summary of the IASB Board discussions and preliminary decisions made at the June IASB Board meeting.
 - (d) Paragraph 23 to 26 provides EFRAG Secretariat assessments of the preliminary decisions made by the IASB Board.
 - (e) Paragraph 27 to 28 contains questions for EFRAG FR TEG.

IASB’s proposals in the ED and EFRAG positions in the published comment letter

- 3 The IASB’s proposals and EFRAG’s position are explained in the table below:

IASB’s Exposure Draft The IASB...	EFRAG’s Comment Letter EFRAG...
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.	supports that liabilities should be classified as either current or noncurrent based on the situation as at the end of the reporting period.
clarifies that 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 Non-current liabilities with Covenants – Cover Note

IAS 1);	
clarifies that 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)	
clarifies that 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).	disagrees with this proposal and recommends deleting subparagraph 72C(b). EFRAG further recommends to consider paragraph 72C(a), in the light of an amendment whose main focus should be on liabilities with covenants.
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	disagrees with this proposal. EFRAG instead recommends requiring the disclosure of this information in the notes.
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.	is concerned that the targeted scope of the disclosure requirements may in practice be too broad and recommends to the IASB in paragraph 76ZA(b) to require the disclosure only in case of significant uncertainties on whether the specified conditions will be met within twelve months after the end of the reporting period, specifying a probability threshold to support consistent application. EFRAG is sympathetic with the concerns about providing forward-looking information with respect to future compliance with covenants. 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 the knowledge gained up to the date of issuance of the financial statements.”

4 Moreover, EFRAG also had the following additional comments:

- EFRAG assesses that the concept of substance (as expressed in paragraph 72A of IAS 1) would benefit from additional guidance and/or examples on how to apply the “substance” requirement. EFRAG also states that it is not clear how the substance requirement interacts with paragraph 72B(b) in situations where conditions are to be tested based on situation shortly after the reporting period, and whether the use of the term has consequences if an entity in its disclosures according to paragraph 76ZA(iii) states that it has no or low expectations of complying with a condition after the end of the reporting period.
- EFRAG recommends to the IASB to clarify the interaction between paragraph 72B(b) and paragraph 75 of IAS 1.

- EFRAG notes that the amendment will leave an unsolved grey area of conditional settlement terms other than covenants, therefore EFRAG also recommends the IASB considers a broader review of the current/non-current classification in the primary financial statements, including on a conceptual view.
- EFRAG notes that the amendment will not solve the underlying issue's root cause of the difficulties encountered in classifying liabilities with conditionalities.
- EFRAG supports the proposed retrospective application as suggested in the amendment of IAS 1 with earlier application permitted.
- 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 these two amendments.

Discussion at the IASB

IASB Staff paper

Classification

- 5 The IASB Staff recommended to finalize the amendments to paragraph 72A of IAS 1 and the addition of paragraph 72B—that is, confirm that only covenants with which an entity must comply on or before the reporting date would affect a liability's classification as current or non-current. The IASB Staff did not recommend any further actions on additional steps addressing the general principles of classification (e.g., paragraph 69(d) of IAS 1).
- 6 The IASB Staff recommended to not provide further clarification or application guidance on determining whether a right to defer settlement has substance or applying paragraphs 74–75 of IAS 1. The IASB Staff mainly points out that more guidance on substance would contradict the narrow scope nature of the project. Moreover, the IASB Staff notes that paragraphs 74–75 of IAS 1 do not contradict the principles in paragraph 72B of IAS 1. Additionally, more guidance on whether to apply paragraph 74 or paragraph 75 of IAS 1 was also not recommended because it would vulnerate the narrow scope character of the project.
- 7 The IASB Staff recommended to not finalise the proposed clarification in paragraph 72C about situations in which an entity would have no right to defer settlement; instead, specify that the proposed requirements in paragraph 72B apply only to liabilities arising from loan arrangements and to not use insurance liabilities as an example anymore. The IASB Staff explained that other solutions would probably vulnerate the narrow scope character of the project.

Disclosures and presentation

- 8 The IASB Staff recommended not finalising the proposal to require an entity to present separately noncurrent liabilities with covenants but instead requiring an entity to disclose the carrying amount of such liabilities in the notes. The IASB Staff acknowledged that feedback revealed no significant risk that investors would be misled if the conditionality of noncurrent liabilities is not highlighted in the statement of financial position but explained only in the notes.
- 9 The IASB Staff also recommended finalising the proposal to require an entity to disclose information about noncurrent liabilities with covenants, with some modifications—specifically, disclose information that enables investors to assess the risk that the liabilities could become repayable within 12 months when an entity classifies liabilities arising from loan arrangements as non-current and those liabilities are subject to covenants including:
 - (a) the covenants with which the entity is required to comply; and

- (b) facts and circumstances that indicate the entity may have difficulty complying with covenants when it is required to do so. Such facts and circumstances could also include the fact that the entity would not have complied with the covenants based on its circumstances at the reporting date.

Thus, the IASB Staff did not recommend finalising the proposals to disclose forward looking information as mentioned under paragraph 76ZA(b)(iii) or also to disclose information that would be required under paragraph 76ZA(b)(ii) reflecting on the compliance at the reporting date. Regarding the latter the IASB Staff acknowledged that non-compliance at the reporting date would probably not be useful in isolation as information on future compliance would be recommended anymore. In fact, the solution presented above under (b) (to add such information as an indicator) is a compromise.

- 10 The IASB Staff did not recommend narrowing the scope of covenants for which an entity would provide information nor provide further guidance on how an entity applies materiality in determining what information to disclose. Regarding the materiality matter the IASB Staff had the view that guidance on materiality was already given in Practice Statement No. 2. Moreover, the IASB Staff did not support restricting the scope because in their view the information would still be important as consequences could be severe even if probabilities of repayment would be low. The IASB Staff also noted that setting a threshold would complicate the standard setting and potentially set a precedent for setting thresholds when new disclosure requirement would be proposed in the future.
- 11 The IASB Staff did not recommend adding to the disclosure requirement under IFRS 7 or to do any changes in IAS 34 *Interim Financial Reporting*.

Transition and other aspects

- 12 The IASB Staff recommended requiring an entity to apply the proposed amendments retrospectively in accordance with IAS 8 and to allow an entity to early adopt the proposed amendments or the 2020 amendments only if the entity early adopts both amendments at the same time. The IASB Staff stated that some disclosure requirements were not proposed anymore and that most criticism with regard to cost aspects would lose relevance.
- 13 The IASB Staff also recommended to defer the effective date of the 2020 amendments to align it with the effective date of the proposed amendments (to be decided at a future meeting, but no earlier than annual reporting periods beginning on or after 1 January 2024)

IASB Board meeting discussion

Classification

- 14 One member suggested to add that the proposed guidance (in paragraph 72B(b) of IAS 1) is an exception in this specific situation and that the guidance should not be used by analogy (e.g., for other liabilities than “loans” with conditionalities).
- 15 One member stated that testing shortly after the reporting period end would be a non-adjusting event even if it would be breached and suggested explanations in the BC.
- 16 All board members agreed unanimously to the recommendations made by the IASB Staff with regard to the classification.

Disclosures and presentation

- 17 One member had doubts what the required disclosures would require the preparer to disclose in addition to current practice. Another board member noted that the proposed disclosures are already practice today (at least in Europe).

- 18 One member stated that disclosing the “terms of covenants” would probably add a significant number of pages to the notes and that the exposure draft should leverage the materiality matter (e.g., as explained in the practice statement) to give a bit more guidance to preparers. Another member did not see the issue that should be addressed using materiality based on current disclosure practice.
- 19 Another member noted that there is a risk as a consequence of the broad scope that the information made available by preparers is too shallow. The member argued that disclosures (quantity of information given) should be proportionate to the increase of risks.
- 20 All board members agreed unanimously to the recommendations made by the IASB Staff to not finalise the requirement for separate presentation. Most board members agreed that disclosures should be proportionate to the risks involved and that this should be discussed in the basis for conclusion and not in the actual requirements (7 of 10).
- 21 All board members agreed unanimously to the recommendations made by the IASB Staff to finalise the requirement for disclosures.
- Transition and other aspects*
- 22 All board members agreed unanimously to the recommendations made by the IASB Staff to finalise the requirement.

EFRAG Secretariat analysis

- 23 The recommendation of the IASB Staff to delete paragraph 72C (also preventing the use of the term insurance liabilities) and add the term “loan arrangements” to paragraph 72B, in order to restrict the scope, are consistent with EFRAG’s comment letter.
- 24 Similarly, the IASB Staff recommendation to not finalising the requirement for separate presentation is aligned with EFRAG’s comment letter.
- 25 EFRAG Secretariat accepts the decision not to provide further guidance on substance. Nevertheless, EFRAG Secretariat would like to highlight that the analysis is very high level (narrow scope character of the project and the statement that such situation would be very unlikely). If the IASB puts the term substance into paragraph 72A of IAS 1 and explains the idea by referencing the Framework, then it is questionable whether the use of the word substance has any merit in 72A.
- 26 EFRAG Secretariat accepts that parts of the disclosures (paragraph 72C(b)(ii)-(iii)) are deleted and that instead the exposure draft formulates a broader requirement for disclosures (e.g., facts and circumstances that indicate the entity may have difficulty complying with covenants). EFRAG Secretariat would like to emphasise that the reference to the Practice Statement No. 2 regarding materiality is not ideal from an EU preparer’s perspective as it is not official part of the published IFRS. Therefore, EFRAG Secretariat welcomes the IASB’s initiative to bring additional explanations even if only in the basis for conclusions.

Question for EFRAG FR TEG

- 27 Are there any additional considerations that should be discussed?
- 28 Do EFRAG FR TEG members agree to the analysis made by EFRAG Secretariat? Why or why not?