European Securities and Markets Authority

The Chair
14 March 2022
ESMA32-61-492

Mr Jean-Paul Gauzès
President
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: EFRAG's due process on the IASB's Exposure Draft Non-current Liabilities with Covenants

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process regarding the IASB's Exposure Draft ED/2021/3 ED/2021/9 *Non-current Liabilities with Covenants.* We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS.

ESMA welcomes the proposals in the Exposure Draft as they address concerns about the outcomes and potential consequences of the amendments to IAS 1 *Presentation of Financial Statements* published in January 2020 and improve the information that an entity provides when its right to defer settlement of a liability is subject to compliance with specified conditions within twelve months after the reporting period.

ESMA supports the classification and disclosure requirements for such liabilities proposed by the IASB. However, we recommend that in finalising the amendments the IASB considers providing more clarity on when certain events are affected or unaffected by the entity's future actions.

ESMA notes that EFRAG expresses concerns in its draft comment letter that the targeted scope of the disclosure requirements may in practice be too broad and suggests to the IASB to elaborate on the application of materiality for such disclosures. ESMA considers that this could give the impression that the relevance of materiality and its application could vary from standard to standard. ESMA emphasises in this context that the concept of materiality is pervasive to the financial statements as a whole.

ESMA expresses doubts that liabilities subject to the conditions described in paragraph 72B(b) classified by an entity as non-current should be presented separately in its statement of financial position as proposed by the IASB. ESMA is concerned that a large majority of borrowings would be included in the new balance sheet caption, so that the separately presented information would be of limited relevance. In case the IASB considers it appropriate to retain the requirement for separate presentation, ESMA recommends refining the criteria for separate presentation.

Finally, ESMA agrees with the effective date and the transition provisions proposed.

Some more detailed comments on the ED are set out in Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Verena Ross

Appendix

Question 1

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.

1. ESMA supports the proposed requirement that specified conditions (often referred to as "covenants") with which an entity must comply within twelve months after the reporting period have generally no effect on the classification of a liability as current or non-current. ESMA agrees with the IASB's view that otherwise the classification outcomes might not provide useful information to users of financial statements.

2. However, ESMA notes that the application of requirements in paragraph 72B(b) is subject to the condition in paragraph 72C(b). In this context, ESMA recommends that the IASB considers providing more clarity on whether events such as "change of control", "timely submission of audited financial statements" or "change of law" are considered to be specified conditions with which the entity is required to comply (often referred to as "covenants") or other conditional settlement terms which do not fall in the scope of the amendments (as indicated in paragraphs BC18-BC20). ESMA recommends a further clarification on whether such events are within the scope of paragraph 72B or 72C and, if so, whether these events are affected by the entity's future actions.

3. ESMA considers that the proposed disclosures in paragraph 76ZA(b) would help users to understand the nature of the conditions and assess the risk that a liability classified as non-current could become repayable within twelve months. However, it is not clear for ESMA why paragraph 76ZA(b)(i) does not require entities to disclose the nature and the date on which the entity must comply with the conditions and only mentions these items as examples.

4. ESMA also notes that paragraphs 74 and 75 of the ED require an entity to classify as current a liability that became payable on demand as a result of a covenant breach on or before the end of the reporting period, unless the lender agrees by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period. However, in ESMA's view, those liabilities subject to covenants which did not become payable on demand on or before the end of the reporting period solely because the lender has waived the formal calculation of the covenant should also be classified as current.

5. ESMA notes that EFRAG expresses concerns in its draft comment letter that the targeted scope of the disclosure requirements may in practice be too broad and suggests to the IASB to elaborate on the application of materiality for such disclosures. ESMA considers that this could give the impression that the relevance of materiality and its application could vary from standard to standard. ESMA emphasises in this context that the concept of materiality is pervasive to the financial statements as a whole and that omitting, obscuring, or misstating material information in the notes could reasonably be expected to influence decisions that primary users of the financial statements make on the basis of those financial statements.

Question 2

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.

6. ESMA expresses doubts that liabilities subject to the conditions described in paragraph 72B(b) classified by an entity as non-current should be presented separately in its statement of financial position as proposed by the IASB. ESMA notes that debt agreements are very often subject to various provisions and may contain a broad range of specified conditions (financial and non-financial) that an entity should comply with. Therefore, ESMA considers that given the risk that a large majority of borrowings will be classified in the new balance sheet caption, the relevance and informative nature of such a separate presentation would be very limited.

7. Should the IASB deem it appropriate to retain the requirement for separate presentation, ESMA recommends refining the criteria for separate presentation to ensure the relevance of the information provided.

Question 3

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.

8. Regarding the relationship between the requirements in paragraphs 72B(b) and 72C(b) of the Exposure Draft, we refer to our comments in paragraph 2 above. In addition, taking into account the requirement in paragraph 25(a) of IAS 32, ESMA considers it helpful to clarify whether the entity has the right to defer the settlement of the liability even if the occurrence of an uncertain future event or outcome that renders the liability repayable is not genuine.

9. ESMA supports the proposed retrospective application, with earlier application permitted, and the proposed effective date.