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Reference: Exposure Draft 2021/9, Non-current Liabilities with Covenants: Proposed amendments to IAS 1

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] welcomes the opportunity to comment on the Exposure Draft 2021/9, Non-current Liabilities with Covenants: Proposed amendments to IAS 1.

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Rogério Lopes Mota
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)

[1]The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), B3 (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

In determining the views of the Brazilian Accounting Pronouncements Committee as to the matter, we have performed outreaches with preparers of financial statements of Brazilian public entities and members of the CPC. We summarized our comments and observations based on our discussion in subtopics below, consistent with the sequence of information provided by the Exposure Draft:

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.

Our response:

(i) on the clarifications provided by the Board

In our view and, based on the feedback received in the outreaches conducted in our jurisdiction, the clarifications made in the Exposure Draft to assert that the 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 are appropriate. This conclusion seems more consistent with the overall classification principle that liabilities are classified as current or non-current on the basis of the rights and obligations that exist at the end of the reporting period and is also consistent with the principles set forth by IAS 10, Events after the Reporting Period.

(ii) on the proposed disclosures

Paragraph 31 of IFRS 7, Financial Instruments: Disclosures determines that an entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. Also, according to IFRS 7.32, this objective is supported by providing disclosures that focus on qualitative and quantitative aspects of the risks arising from financial instruments and how those risks have been managed. Among others, those risks would include liquidity risk (which is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset).

Discussing liquidity risk, IFRS 7.B10A states that an entity should disclose summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel and that if the outflows of cash (or another financial asset) included in those data could either: (a) occur significantly earlier than indicated in the data, or (b) be for significantly different amounts from those indicated in the data. In such situation, the entity shall state that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analyses.

The related Basis for Conclusion emphasises that the extent of these disclosures depend on the extent of an entity's exposure to risks arising from financial instruments and, as such, entities with many financial instruments and related risks (which we believe may include non-current financial liabilities subject to covenants required within 12 months after the reporting date) should provide more disclosure and those with few financial instruments and related risks may provide less extensive disclosure.

We also transcribe below a similar discussion that has been included in the IFRS Practice Statement 2 - Making Materiality Judgments, which in our view seems complementary to the IFRS 7 discussion included above:

> *"Information about covenants*
>
> *81 An entity assesses the materiality of information about the existence and terms of a loan agreement clause (covenant), or of a covenant breach, to decide whether to provide information related to the covenant in the financial statements (…)*
>
> *82 In particular, when a covenant exists, an entity considers both:*
>
> *(a) the consequences of a breach occurring, that is, the impact a covenant breach would have on the entity's financial position,*

financial performance and cash flows. If those consequences would affect the entity's financial position, financial performance or cash flows in a way that could reasonably be expected to influence primary users' decisions, then the information about the existence of the covenant and its terms is likely to be material. Conversely, if the consequences of a covenant breach would not affect the entity's financial position, financial performance or cash flows in such a way, then disclosures about the covenant might not be needed.

(b) the likelihood of a covenant breach occurring. The more likely it is that a covenant breach would occur, the more likely it is that information about the existence and terms of the covenant would be material.

83 In assessing whether information about a covenant is material, a combination of the considerations in paragraph 82(a)-82(b) applies. Information about a covenant for which the consequences of a breach would affect an entity's financial position, financial performance or cash flows in a way that could reasonably be expected to influence primary users' decisions, but for which there is only a remote likelihood of the breach occurring, is not material.

Example P—assessing whether information about covenants is material

Background

An entity has rapidly grown over the past five years and recently suffered some liquidity problems. A long-term loan was granted to the entity in the current reporting period. The loan agreement includes a clause that requires the entity to maintain a ratio of debt to equity below a specified threshold, to be measured at each reporting date (the covenant). According to the loan agreement, the debt-to-equity ratio has to be calculated on the basis of debt and equity figures as presented in the entity's IFRS financial statements. If the entity breaches the covenant, the entire loan becomes payable on demand. The disclosure of covenant terms in an entity's financial statements is not required by any local laws or regulations.

Application

Paragraph 31 of IFRS 7 Financial Instruments: Disclosures requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risk arising from financial instruments to which the entity is exposed at the end of the reporting period.

> *In the preparation of its financial statements, the entity assesses whether information about the existence of the covenant and its terms is material information, considering both the consequences and the likelihood of a breach occurring.*
>
> *In these circumstances, the entity concluded that, considering its recent liquidity problem, any acceleration of the long-term loan repayment plan (the consequence of the covenant breach occurring) would affect the entity's financial position and cash flows in a way that could reasonably be expected to influence primary users' decisions.*
>
> *The entity also considered the likelihood of a breach occurring."*

As such, we believe that while the disclosures suggested are likely to provide relevant information for the users of the financial statements, those are already in essence part of the disclosure requirements set forth by IFRS 7. However, if more specific and granular requirements including (i) the conditions; (ii) whether the entity would have complied with those conditions based on its circumstances at the end of the reporting period; and (iii) whether and how the entity expects to comply with the conditions after the end of the reporting period are deemed relevant, we believe that those would be better presented as amendments to IFRS 7 rather than IAS 1.

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

Our response:

IAS 1 explicitly recognises that professional judgment is applied when classifying and/or aggregating the diverse transactions that flow through an entity's financial statements, being the extent of this aggregation assessed on the basis of materiality (that is, each material class of similar items to be presented separately in the financial statements; and items of a dissimilar nature or function to be presented separately unless they are immaterial).

Materiality as defined in IAS 1 and IAS 8 (by cross reference to IAS 1) specifies that "Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity".

Information is deemed obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information, such as (a) information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear; (b) information regarding a material item, transaction or other event is scattered throughout the financial statements; (c) dissimilar items, transactions or other events are inappropriately aggregated; (d) similar items, transactions or other events are inappropriately disaggregated; and (e) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

On the other hand, IAS 1.31 suggests that the provision of additional disclosures is a response to be utilised by the preparers to ensure that the users of the financial statements understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Consistent with this principle, the IFRS Practice Statement 2 provides a discussion on this regard, as outlined on its paragraphs 81 through 83 and the Example P, transcribed above in the previous response. This abovementioned discussion is consistent with the Board's statement (November 2021's Snapshot: Non-current Liabilities with Covenants) that the information provided by classification as either current or non-current, alone, is insufficient to meet investor information needs as such classification does not necessarily provide information about the potential effects of covenants on when the liability is repayable.

However, in our view and consistent with the literature referred to above, the concerns expressed by the Board are historically addressed (not only as it relates to financial liabilities within the scope of IFRS 9, but also for the other diverse line items associated with other IFRS standards as well as the suggestion for covenants presented in the IFRS Practice Statement 2) on the basis of additional disclosures rather than creating additional classification requirements for separating the liabilities in different line items.

IAS 1.30A also states when applying IAS 1 and other IFRSs that an entity should decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which include the notes. In particular, the understandability of financial statements should not be reduced by obscuring material information with immaterial information or by aggregating material items that have different natures or functions. In our opinion, addressing

the relevance and/or risks associated with such liabilities subject to covenants that will be measured in the upcoming 12 months from the reporting date on the basis of extended disclosures when material (rather than a separate presentation in the statement of financial position) does not seem to obscure material information or harm the understandability of the transaction as reported in the financial statements.

According to the information provided in the Exposure Draft's Basis for Conclusions, the suggestion of separate presentation in the statement of financial position has been proposed to serve as an alert to users of the financial statements, providing an emphasis to those balances with the intent to influence those users to seek additional information on those conditions in the notes to the financial statements. This separation on the basis of providing an emphasis for the users of the financial statements is in our view excessive. While we acknowledge that effective communication in financial statements makes information more relevant as it enhances understandability, financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (as also provided for in the Conceptual Framework for Financial Reporting). As such, diligence in reviewing such information is also an expectation that the entities have when preparing disclosures (as also discussed on paragraph 15 of the IFRS Practice Statement 2).

As such, as it relates to separate presentation, we believe that current IFRS guidelines, especially those provided by IAS 1 and the Conceptual Framework for Financial Reporting already address this matter. According to IAS 1.29, an entity shall present separately each material class of similar items and shall present separately items of a dissimilar nature or function unless they are immaterial. Whether the non-current liabilities subject to covenants required within 12 months after the reporting date are sufficiently dissimilar to those with covenants not required in the same period in that regard is a matter of judgment. Utilising the IFRIC discussion on the matter of whether supply chain financing arrangements merit separate presentation (IFRIC tentative agenda decision on project Supply Chain Financing Arrangements - Reverse Factoring, April through June 2020), the tentative agenda decision concluded that in assessing whether to present such liabilities separately (including whether to disaggregate trade and other payables), an entity considers the amounts, nature and timing of those liabilities as well as whether the terms of liabilities that are part of the arrangement are substantially different from the terms of the entity's trade payables that are not part of the arrangement.

That conveys a view in a similar discussion that separate presentation would assume terms and conditions that are "substantially different" from the line item that includes the remaining transactions presented. As the term "substantially different" is not defined under IFRS, we consider similar guidance in accounting literature that provides a basis for our conclusion. Consistent with the IASB staff (views provided on the October 2019 staff meeting for the IBOR Reform and its

Effects on Financial Reporting project, where a topic “how to determine whether a modification is substantial” had been included in the agenda), determining whether the terms of a financial liability are substantially different from a qualitative perspective depends on the specific facts and circumstances that apply to each case and may vary from jurisdiction, product types and agreements, among others. Also, according to the IASB staff, a modification deemed substantial would be those that result in “a significant value transfer and/or a new underwriting/pricing assessment of the financial instrument, including the following examples: (a) modifications to the currency on which the financial instrument is denominated; (b) a significant extension of the maturity date; (c) modifications to a floating-rate financial instrument so that if becomes a fixed rate financial instrument; and (d) modifications to contractual cash flows that would cause a financial asset that passed the solely payments of principle and interest assessment (SPPI) before to fail that assessment because of the modifications”.

The abovementioned examples of “substantially different” terms and conditions on financial liabilities are in our view more significant than those that are under discussion in this Exposure Draft. It could also raise the question on whether other terms and conditions that typically apply to such financing liabilities could be deemed equally or more significant to users of financial statements to the point of also deeming separate presentation (bearing in mind that the entities may have different profile of primary users with different concerns that may value one aspect or another relating to debt, such as different interest rates, currency on which the financial liability is denominated, guarantees, among others) and, in light of the guidance provided by the Exposure Draft, would be obscured by the emphasis included in the presentation in the statement of financial position to other terms and conditions empirically determined to be separate by the standard (the non-current liabilities subject to covenants required for within 12 months after the reporting period).

As such, we do not agree with the proposed suggestion 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.

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.

Our response:

While we draw attention to the responses provided in the previous questions, we agree with the proposed clarification specified in 3(a) above as well as with items 3(b) and 3(c).

On an additional note, we would like to use the opportunity to refer to a long-standing disagreement we have with the guidelines for the presentation of a liability as current when the entity breaches a covenant, but the lender has agreed after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. This is defined in paragraphs 74 through 76 transcribed below:

> *"74 When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.*

> *75 However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.*
>
> *76 In respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting events in accordance with IAS 10 Events after the Reporting Period: (a) refinancing on a long term basis; (b) rectification of a breach of a long term loan arrangement; and (c) the granting by the lender of a period of grace to rectify a breach of a long term loan arrangement ending at least twelve months after the reporting period."*

We believe that as the project discusses aspects relating to financial liabilities subject to covenants this would be a good opportunity to revise the guidance provided by IAS 1 in that regard. We draw attention to the discussion on the qualitative features set out in the IFRS Conceptual Framework for Financial Reporting, which states that if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

In light of this precedent, there is a hard evidence of what the IFRS "principles-based nature" is all about, entailing that the preparation of the financial statements should be guided by coherent guidance on recognition, measurement and disclosure of economic and/financial events, rather than only through formal reading that leads to straightforward box-ticking without any judgment of value when choosing accounting practices for recognition and disclosure. Also, worth noting is that the primary conceptual guidance that has inspired and still inspires the IFRS and their effects on the national accounting system stem from the assumption that any accounting record is valid and relevant only if supported by robust economic grounds ("accounting follows economics"). Likewise, the preparation of accounting reports under the guidance of such system should depict the economic types and features, which again should support each entity' accounting records and eventually allow the organization to be clearly seen as one which raises and invests funds, produces cash flows and increases or reduces its equity by generating profits or losses.

Still with regards to faithful accounting information, the IFRS Conceptual Framework for Financial Reporting also sets out three unequivocal conditions to attain such information, to wit:

> *"2.12 Financial reports represent economic phenomena in words and numbers. <u>To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.</u>*
>
> *2.13 To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible."*

In accordance with the red book, paragraphs 14 through 76 were originally issued upon the introduction of IAS 1 in 1997 and slightly revised in 2002. Such long-lived text has been in force and unrevised for a long period of time, preceding also the joint initiative between FASB and IASB to approve a Conceptual Framework for Financial Reporting kicked off in 2006. The anachronistic provision in such paragraphs, vis-à-vis the principles-based contents of the IFRS Conceptual Framework for Financial Reporting, sheds light into more than a simple mismatching of deadlines among standards, since, in accordance with the taxonomy to formulate an IFRS, the stages of proposal or revision of a document are strongly influenced by the wording of the IFRS Conceptual Framework for Financial Reporting. Thus, inconsistencies between the period of issuance of a general standard and that of specific rules would shape a fruitful environment for misalignment of purposes within the same set of accounting standards.

As such, in our views it is not appropriate under the principles of IFRS as expressed in the IFRS Conceptual Framework for Financial Reporting that IAS 1 requires reclassifications to current liabilities in connection with one-off violation of covenants whenever economic and business circumstances, if any, result in such reclassifications not fully reflecting an entity's actual economic and financial information.

Therefore, the maintenance of such general accounting rule not only skews the significance of the financial statements, but also brings actual losses to the organizations, as other creditors, in connection with such reclassification, may misinterpret that a company is experiencing insurmountable financial restrictions and require its rights to be early settled, causing a wide range of misstatements. In light of the grounds reported throughout this paper, we suggest that the application of the guidelines addressed in paragraphs 74 to 76 of IAS 1 be modified, allowing the retroactive consequence of a subsequent event which is able to remove the dire consequences of a covenant flagged as "breach" at the balance sheet date, but no longer so at the time the financial statements are issued.