

## STAFF PAPER

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## IASB Meeting

Project	Materiality Practice Statement		
Paper topic	Sweep issues—covenants		
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**Purpose and structure of this paper**

1. The purpose of this paper is to ask the International Accounting Standards Board (the Board) whether to confirm the proposed guidance on covenants in the draft IFRS Practice Statement *Making Materiality Judgements* (the Practice Statement) in the light of comments received.
2. The Paper is set out as follows:
  - (a) background information;
  - (b) issue 1—information about covenants;
  - (c) issue 2—impact of covenants on materiality of other information; and
  - (d) Appendix A—extracts from the latest staff draft of the Practice Statement.

## Background information

3. In November 2016<sup>1</sup> the Board discussed some of the issues raised by respondents to the Exposure Draft IFRS Practice Statement *Application of Materiality to Financial Statements* (the Exposure Draft) and tentatively decided to:
  - (a) include in the final Practice Statement specific guidance on how to assess the materiality of information about the existence and the terms of a covenant, or a covenant breach; and
  - (b) emphasise that, in making the above assessment, an entity considers the consequences of a covenant breach on the entity's financial position, financial performance and cash flows; and the likelihood of such a breach occurring.
4. The Board also tentatively decided that an entity is not required to re-perform its materiality assessments the closer it gets to breaching a covenant. In other words, the existence of a covenant should not influence the materiality assessment of other information in the financial statements—other than information about the covenants. In making this decision, the Board noted the impracticality, from an operational point of view, of requiring an entity to continuously reassess its materiality judgments the closer it gets to a covenant breach.
5. In December 2016<sup>2</sup> the Board examined the due process steps undertaken since the publication of the Exposure Draft and instructed the staff to begin the balloting process.
6. In March 2017, the staff issued for review a draft of the Practice Statement to a number of external parties. The same draft was also made available to members of the Board and the IFRS Interpretations Committee.

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<sup>1</sup> Agenda Paper 11B *Covenants* from November 2016.

<sup>2</sup> Agenda Paper 11C *Due process steps followed* from December 2016.

7. The draft Practice Statement considers two issues that arise in making materiality judgements when covenants, or similar contractual terms, apply:
- (a) how an entity judges the materiality of information about the existence and the term of a covenant or of a covenant breach (see **issue 1**, paragraphs 8–16); and
  - (b) whether the entity considers the existence of a covenant when making materiality judgements about other information included in the financial statements (see **issue 2**, paragraphs 17–43).

### **Issue 1—information about covenants**

8. The draft Practice Statement states that, in addition to the materiality factors described in the materiality process,<sup>3</sup> materiality judgements on information about covenants are specifically influenced by the *consequences* of a covenant breach occurring and the *likelihood* of such a breach occurring (paragraph 83 of the draft Practice Statement<sup>4</sup>).
9. In particular, information about a covenant for which the consequences of a breach would significantly affect the entity’s financial position, financial performance or cash flows, but for which there is a remote likelihood of the breach occurring, is not material (paragraph 84 of the draft Practice Statement).
10. In other words, regardless of the significance of the consequences of a breach occurring, information about the covenant is not material—does not need to be included in the financial statements—if the likelihood of a breach occurring is remote.

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<sup>3</sup> The materiality process has been discussed by the Board in October 2016, Agenda Paper 11C *The Materiality Process*.

<sup>4</sup> Relevant extracts from the latest staff draft of the Practice Statement are provided in **Appendix A**.

11. Some external reviewers, including some audit firms and standard-setters, questioned whether the guidance in paragraph 84 of the draft Practice Statement introduces a new ‘disclosure threshold’, as it suggests that information about the covenants will always be material when the likelihood of a covenant breach occurring is higher than remote.
  
12. One reviewer noted that the disclosure threshold in paragraph 84 of the draft Practice Statement is equivalent to the disclosure threshold on contingent liabilities in paragraph 28 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*:
 

A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is *remote* [emphasis added].
  
13. However, the same reviewer also observed that a contingent liability and the consequences on an entity’s financial statements of a covenant breach occurring are two different situations. The potential impact of a contingent liability is an expense and an impact on equity, while the impact of a covenant breach depends on the terms of the covenants and might have more significant consequences.
  
14. Paragraph 10 of IAS 37 defines a contingent liability as:
 

... a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of *one or more uncertain future events* not wholly within the control of the entity ... [emphasis added].
  
15. Contingent liabilities and consequences of a covenant breach occurring are similar because both are affected by uncertain future events.

16. We therefore believe that paragraph 28 of IAS 37 provides the basis for confirming the guidance on the disclosure of information about covenants in the Practice Statement. However, in the light of:
- (a) the comments received on the draft Practice Statement; and
  - (b) the fact that this disclosure threshold was not specifically discussed during November 2016 Board meeting;<sup>5</sup>

we would like you to confirm whether the guidance in the final Practice Statement should state that information about a covenant is not material if the likelihood of the breach occurring is remote.

**Question 1—information about covenant**

Do you agree that the final Practice Statement should state that, on the basis of the requirement in paragraph 28 of IAS 37, information about the covenant is not material if the likelihood of the breach occurring is remote?

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<sup>5</sup> The disclosure threshold was nevertheless mentioned in paragraph 11 of the Agenda Paper 11B *Covenants* from November 2016.

**Issue 2—impact of covenants on materiality of other information**

17. The draft Practice Statement states that, since covenant terms are often defined on the basis of information in IFRS financial statements, an entity makes materiality judgements about this information without being influenced by the existence of the covenant (paragraph 85 of the draft Practice Statement).
18. The entity makes materiality judgements in the preparation of its draft financial statements without considering the existence of covenants and assesses its compliance with any covenant once the draft financial statements have been prepared (paragraph 86 of the draft Practice Statement).
19. The Board decided to provide the guidance described in paragraphs 17–18 in response to comments received on the Exposure Draft. The Exposure Draft presented covenant compliance as an example of a situation where materiality considerations would be more sensitive because they relate to areas of particular importance to the primary users of an entity’s financial statements (paragraph 28(a) of the Exposure Draft). Respondents<sup>6</sup> suggested the Board clarify whether an entity needs to reassess its materiality judgements when it is close to non-compliance with a loan covenant.
20. In making its tentative decision in November 2016, the Board observed that:
  - (a) when compliance with a covenant is assessed on the basis of information in IFRS financial statements, that assessment must, by definition, follow, rather than precede, the preparation of those statements. To require that the assessment of such a covenant influences the preparation of the information on which the covenant is assessed would create a circular assessment and would be impractical from an operational point of view.
  - (b) if lenders decide to define covenant terms on the basis of information in IFRS financial statements, they need to accept that those financial statements are prepared making materiality judgements.

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<sup>6</sup> EY, the Belgian Accounting Standards Board and the Italian Standard Setter, among others.

21. However, some external reviewers noted that the guidance provided in paragraphs 85–86 of the draft Practice Statement seems to conflict with U.S. Securities and Exchange Commission (SEC) guidance on assessing materiality. The SEC Staff Accounting Bulletins, Topic 1: Financial Statements, M. Materiality, includes among the considerations that may render material a quantitatively small misstatement, the fact that the misstatement affects the entity’s compliance with loan covenants or other contractual requirements.
22. Similarly, some audit regulators require auditors to consider covenants when establishing audit materiality. In particular, the International Standard on Auditing (ISA) 450 *Evaluation of misstatements identified during the audit* states that the effect on the compliance with debt covenants or other contractual requirements may cause the auditors to evaluate a misstatement as material.
23. Some reviewers also commented that guidance conflicting with existing local laws and regulations might be seen as a change, or a new interpretation, of existing requirements in IFRS Standards, which would be contrary to the notion that a Practice Statement is not supposed to change existing requirements or introduce any new interpretations.
24. In the light of:
  - (a) the comments received; and
  - (b) the potential inconsistencies between the guidance in the draft Practice Statement and guidance developed by other parties on the assessment of materiality of errors;

we decided to ask the Board whether to confirm its decision.

25. In our view there are three possible alternatives the Board could choose from:
- (a) **Alternative A**—retain the guidance in paragraphs 85–86 and Example Q of the draft Practice Statement (‘Impact of covenants on materiality of other information’ section), reminding entities that local laws or regulations might require an entity to consider compliance with debt covenants or other contractual requirements when assessing the materiality of an error;
  - (b) **Alternative B**—remove the guidance in paragraphs 85–86 and Example Q from the draft Practice Statement; or
  - (c) **Alternative C**—replace the guidance in paragraphs 85–86 and Example Q of the draft Practice Statement with alternative guidance (for example, guidance stating that materiality judgements should be influenced by the existence of covenants).

### ***Alternative A—retain***

26. The Board could choose to retain the current guidance in paragraphs 85–86 and Example Q of the draft Practice Statement and add a reference to the fact that local laws and regulations might require a different—stricter—assessment of materiality (especially with regards to the assessment of the materiality of errors).
27. The draft Practice Statement already includes some guidance on the interaction with local laws and regulations (paragraphs 27–28 of the draft Practice Statement). An entity that wishes to state compliance with IFRS Standards cannot provide less information than the information required by those Standards, even if local laws and regulations permit otherwise. However, providing information to meet local legal or regulatory requirements is permitted by IFRS Standards, even if that information is not material according to the materiality requirements in the Standards.
28. The reasons for choosing Alternative A are the same as those that drove the Board’s tentative decision in November 2016 (see paragraph 20).

29. However, there are some concerns related to Alternative A:
- (a) the current guidance on the impact of covenants on other materiality assessment might create some confusion among preparers due to the existence of conflicting guidance in the auditing standards and local regulations. This would clash with one of the purposes of the Practice Statement—to provide a basis for discussion between an entity, its auditor and regulator on the assessment of materiality, which could help facilitate agreement.
  - (b) even if the Board tries to address the inconsistency issue adding a reference to the fact that local laws and regulations might require a stricter assessment of materiality, some might argue that guidance in auditing standards and local regulations is not just ‘stricter’ than the guidance proposed in the draft Practice Statement—it is developed on completely different grounds (ie the impact on covenant compliance is considered as a qualitative factor affecting materiality assessment).
  - (c) as mentioned in paragraph 23, guidance conflicting with existing local laws and regulations might be seen as a change, or a new interpretation, of existing requirements in IFRS Standards. A Practice Statement should not change any existing requirements in IFRS Standards, nor introduce any new requirements.

### ***Alternative B—remove***

30. The Board could remove paragraphs 85–86 and Example Q from the draft Practice Statement.
31. Alternative B avoids creating any actual or perceived change in the way an entity assesses materiality when covenants or other contractual requirements apply. However, if the Board chooses Alternative B, the Practice Statement would fail to provide preparers with useful guidance in an area that it is difficult to make materiality judgements.

32. If the Board supports Alternative B, it could retain in the final Practice Statement guidance on how to assess the materiality of information related to covenants (paragraphs 82–84 and Example P of the draft Practice Statement). That guidance is uncontroversial and, we believe, could result in relevant disclosures about the existence of covenants and the consequences of their breach.

### ***Alternative C—replace***

33. The Board could decide to replace the proposed guidance in the draft practice statement with guidance that is more aligned with the content of the Exposure Draft. To do this the Board would need to agree that the existence of covenants, or other similar contractual requirements, can influence materiality judgements (ie the existence of covenants is a qualitative factor affecting materiality assessment).
34. Alternative C eliminates potential conflicts with current auditing guidance and local regulations. However, the Board risks suggesting something that is impractical from an operational point of view (ie requiring a continuous reassessment of materiality judgements the closer the entity gets to a covenant breach).
35. Moreover, as observed by the Board during its discussion in November 2016, if lenders decide to define covenant terms on the basis of information in IFRS financial statements, they need to accept that those financial statements are prepared making materiality judgements.
36. Finally, stating that materiality judgements are influenced by the existence of covenants might imply that those judgements are also influenced by other contracts whose terms are based on information from IFRS financial statements (eg profit sharing agreements, management incentive plans, etc.).

**Staff recommendation**

37. Each of the alternatives we described in paragraphs 26–36 has pros and cons. In formulating our recommendation, we primarily considered the objectives the Board expected to achieve with the publication of the Practice Statement.
38. In particular, the Board expects the Practice Statement will:
- (a) enhance awareness of the role of materiality in helping to promote positive changes in behaviour (such as to discourage rigid adherence to checklists by an entity when preparing financial statements);
  - (b) encourage an entity to exercise judgement to a greater extent in preparing financial statements, leading to a reduction in boilerplate disclosures and redundant information and providing a framework to assess the need for information in the financial statements that is additional to disclosure requirements specified by IFRS Standards; and
  - (c) provide a useful reference point for discussions between an entity, its auditors and regulators on the assessment of materiality, which could help facilitate agreement.
39. Moreover, when discussing the audience of the Practice Statement,<sup>7</sup> the Board noted that the Practice Statement is also likely to help other parties involved in financial reporting (such as, for example, auditors and regulators) understand the approach an entity follow in making materiality judgements when preparing its financial statements.
40. We believe that the Board might fail to meet these objectives if it retains the current guidance on the impact of covenants on other materiality assessment in the final Practice Statement. That guidance might create confusion among parties involved in financial reporting due to the existence of conflicting guidance in auditing standards and local regulations. This confusion could risk undermining the entire Practice Statement reducing the effectiveness of the document.

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<sup>7</sup> Agenda Paper 11B *Audience, focus and definition* from October 2016.

41. We also believe that replacing the proposed guidance in the draft practice statement with guidance that is more aligned with the content of the Exposure Draft is not advisable either. The Board risks suggesting an endless reassessment of the materiality judgements that might lead to a situation where all figures in the financial statements might become material.
42. We therefore recommend the Board chooses **Alternative B**—remove paragraphs 85–86 and Example Q from the draft Practice Statement.
43. We recommend retaining the guidance on how to assess the materiality of information related to covenants (paragraphs 82–84 and Example P of the draft Practice Statement). This guidance is uncontroversial and, we believe, could result in relevant disclosures about the existence of covenants and the consequences of their breach.

**Question 2—impact of covenants on materiality of other information**

Do you agree that the Board:

(a) removes the guidance about the impact of covenants on materiality judgements about other information (paragraphs 85–86 and Example Q of the draft Practice Statement) from the final Practice Statement? and

(b) retains the guidance about how to assess the materiality of information related to covenants (paragraphs 82–84 and Example P of the draft Practice Statement) in the final Practice Statement?

## Appendix A—extracts from the latest staff draft of the Practice Statement

A1. Proposed guidance on covenants and on the interaction with local laws and regulations from the latest staff draft of the Practice Statement is reproduced below.

### Covenants

- 81 Two considerations arise in making materiality judgements when loan agreement terms (covenants), or similar contractual terms, apply:
- (a) how an entity judges the materiality of information about the existence and terms of a covenant, or of a covenant breach; and
  - (b) whether the entity considers the existence of a covenant when making materiality judgements about other information included in the financial statements.

### Information about covenants

- 82 An entity assesses the materiality of information about the existence and terms of a covenant, or of a covenant breach, to decide whether to provide that information in the financial statements. This assessment is made in the same way as for other information, ie by considering whether that information could reasonably be expected to influence decisions that its primary users make on the basis of the entity’s financial statements (see ‘A four-step materiality process’, from paragraph 33).
- 83 In particular, when a covenant exists, the entity considers both:
- (a) the consequences of a breach occurring, ie the impact a covenant breach would have on the entity’s financial position, financial performance and cash flows. If those consequences would significantly impact the entity’s financial position, financial performance or cash flows, 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 significantly impact the entity’s financial position, financial performance or cash flows, then disclosures about the covenant might not be needed.
  - (b) the likelihood of the covenant breach occurring. The more likely it is that the covenant breach would occur, the more likely it is that information about the existence and terms of the covenant would be material.
- 84 In assessing whether information about a covenant is material, a combination of the above considerations applies. Information about a covenant for which the consequences of a breach would significantly affect the entity’s financial position, financial performance or cash flows, but for which there is a remote likelihood of the breach occurring, is not material.

#### **Example P—assessing whether information about covenants is material information**

##### **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 long-term loan arrangement includes a provision 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 long-term loan arrangement, 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 long-term loan becomes payable on demand. The disclosure of covenant terms in an entity’s financial statement 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 assessed the consequences of the breach occurring as being significant: considering its recent liquidity problem, any acceleration of the long-term loan repayment plan could significantly impact the entity's financial position and cash flows.

The entity also considered the likelihood of a breach occurring.

**Scenario 1—the lender defined the covenant threshold on the basis of the three-year business plan prepared by the entity, adding a 10 per cent tolerance on top of the forecast figures**

In this scenario, even though the entity has historically met its past business plans, it assessed the likelihood of a breach occurring as higher than remote. Therefore, information about the existence of the covenant and its terms was assessed as material and disclosed in the entity's financial statements.

**Scenario 2—the lender defined the covenant threshold on the basis of the three-year business plan prepared by the entity, adding a 200 per cent tolerance on top of the forecast figures**

In this scenario, the entity assessed the likelihood of a breach occurring as remote, on the basis of its historical track record of meeting its past business plans and the magnitude of the tolerance included in the covenant threshold. Therefore, although the consequences of the covenant breach were assessed as significant, the entity concluded that information about the existence of the covenant and its terms was not material.

**Impact of covenants on materiality of other information**

- 85 Covenant terms are often defined on the basis of other information in IFRS financial statements, eg the amount of equity or debt (sometimes called 'inputs of the covenant calculation'). An entity makes materiality judgements about this other information without being influenced by the existence of the covenant.
- 86 The entity makes materiality judgements in the preparation of its draft financial statements without considering the existence of covenants and assesses its compliance with any covenant, or similar contractual terms, once the draft financial statements have been prepared. The draft financial statements are then adjusted accordingly in the case of a covenant breach (eg by changing the classification of the liability arising from a long-term loan from non-current to current).

**Example Q—making materiality judgements on the input of a covenant calculation****Background**

Assume the same facts as in **Example P, Scenario 1**, except that the long-term loan arrangement requires the entity to maintain the amount of property, plant and equipment (PP&E) additions for each reporting period below a specified threshold, to be measured at each reporting date (the covenant). According to the long-term loan arrangement, the amount has to be calculated on the basis of PP&E figures as included in the entity's IFRS financial statements.

The entity has historically applied a policy of capitalising capital expenditures only in excess of a specified threshold and recognising any smaller amounts as an expense.

**Application**

In the preparation of its financial statements, the entity applied the considerations outlined in the materiality process to assess whether this accounting policy would have a material effect on its financial statements. It exercised its judgement and concluded that the accounting policy will not have a material effect on the current financial statements.

While verifying its compliance with the covenant terms, the entity realised that a lower capitalisation threshold would have caused it to breach the covenant. However, since compliance with the covenant terms is assessed on the basis of IFRS financial statements, whose preparation inherently involves the assessment of materiality, the potential breach of the covenant should not influence the entity's materiality judgements on the accounting policy.

The entity confirmed the materiality assessment of its capitalisation policy and concluded the covenant was not breached.

**Interaction with local laws and regulations**

- 27 An entity's financial statements must comply with the requirements in IFRS Standards, including requirements related to materiality (the materiality requirements), for the entity to state its compliance with those Standards. Hence, an entity that wishes to state compliance with IFRS Standards cannot provide less information than the information required by those Standards, even if local laws and regulations permit otherwise.
- 28 Nevertheless, local laws and regulations may specify requirements that affect what information is provided in the financial statements. In such circumstances, providing information to meet local legal or regulatory requirements is permitted by IFRS Standards, even if that information is not material according to the materiality requirements in the Standards. However, such information must not obscure information that is material according to IFRS Standards.<sup>8</sup>

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<sup>8</sup> See paragraph 30A of IAS 1 and paragraph BC30F of the Basis for Conclusions on IAS 1.