

STAFF PAPER

November 2016

IASB Meeting

Project	Disclosure Initiative: Materiality		
Paper topic	Covenants		
CONTACT(S)	Aisling Carney	acarney@ifrs.org	+44 (0)20 7246 6408
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7246 6922

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS[®] Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB[®] *Update*.

Purpose of this paper

1. This paper considers the comments received on the Exposure Draft and should be read together with Agenda Paper 11 *Materiality - Cover Paper*. It asks the Board whether, in the light of comments received, further guidance on the impact of covenants on the application of materiality should be included in the final *Practice Statement*.

Guidance proposed in the Exposure Draft

2. There was only one mention of covenants in 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).

Summary of the feedback

3. Respondents to the Exposure Draft asked for more guidance on assessing the materiality of information about covenants. They asked for more discussion on the circumstances that would make information about a covenant or a covenant breach material. They also asked the Board to provide more examples of

situations when the materiality assessment may be more sensitive due to the application of covenants.

4. For example, EY understood the proposed guidance to mean that there may be:

... disclosures that are material for the items for which the regulatory requirements or loan covenants apply that would not be material without those externally imposed restrictions. (...) if the Board is of a view that other materiality assessments may also be impacted, it should be clarified (CL70).

5. The Belgian Accounting Standards Board (BASB) stated that:

It would be helpful if the Board further clarified whether, in a situation where an entity is close to non-compliance with a regulatory requirement or loan covenant, it would need to not only provide a general disclosure of this fact, but also reassess every previously made materiality assessment because of a decrease in the materiality level (CL12).

6. Finally, the Italian Standard Setter (OIC) said that the Exposure Draft should be more principles based. It observed that the example in the Exposure Draft:

... seems to say that the closer the entity is to breaching a covenant, the lower the materiality should be. This may lead to a situation where materiality is set to a value that implies that almost all figures in the financial statements are material (CL96).

Staff analysis

7. We agree with the respondents that there is a need to provide more guidance on the relationship between covenants and materiality. There are two materiality considerations that arise when covenants apply:

- (a) how to assess the materiality of information about the existence and the terms of a covenant, or a covenant breach; and

- (b) how to assess the impact of the existence of a covenant on the materiality assessment of other information included in the financial statements.

Information about the existence and the terms of a covenant, or a covenant breach

8. In order to decide whether information about the existence and the terms of a covenant, or information about a covenant breach, should be included in the financial statements an entity would need to assess whether that information is material. This assessment is made in the same way as the assessment of other information, ie considering whether information about the existence and the terms of the covenant, or the covenant breach, could reasonably be expected to influence the decisions of the primary users of an entity’s financial statements.
9. We described an example of the process that an entity may follow in making its materiality assessment in the Agenda Paper 11D *The Materiality Process* presented to the Board in October 2016.
10. In assessing the materiality of information about covenants, it is necessary for an entity to consider:
 - (a) what are the *consequences* of a breach occurring, ie the impact the covenant breach would have on the entity’s financial position, financial performance and cash flows. If the consequences of a covenant breach would be material, then information about the existence of the covenant and its terms is likely to be material.
 - (b) the *likelihood* of a covenant breach occurring. The more likely a covenant breach is to happen, the more likely it is that information about the existence and the terms of the covenant could reasonably be expected to influence the decisions of the primary users of an entity’s financial statements.
11. If the breach of a covenant would have a material impact on the entity’s financial position, financial performance and cash flows, information about the covenant would be material unless the likelihood of a breach is considered to be remote. On the other hand, information about a covenant whose breach consequences

would be material *but* for which there is a remote likelihood of the breach occurring, might not be material.

Impact of the existence of a covenant on the materiality assessments of other information included in the financial statements

12. The second issue arising in relation to covenants is whether the existence of a covenant affects the materiality assessment of other information included in the financial statements. In particular, the other information would be the inputs to the covenant trigger.
13. For example, if a covenant required the ratio of debt to equity to be below a specified number, does the existence of the covenant affect the materiality assessment in relation to the recognition and measurement of the entity's debt and the entity's equity? This was the issue raised by the OIC in its comment letter (see paragraph 6 of this paper).
14. In our view, the existence of a covenant, in addition to being assessed as material information itself, could affect the materiality assessment of the inputs that determine if the covenant is breached.
15. In Agenda Paper 11D presented to the Board in October 2016, we stated that an entity might conclude that an item of information is material for a number of different reasons. There are no bright lines—ultimately the entity must apply judgement, nevertheless we proposed in that paper some common materiality 'factors' that can be used to help identify when an item of information is material.
16. Among the *qualitative* factors¹ listed we identified 'actual or expected non-compliance with laws, regulations or contractual terms (including covenants)' (paragraph 41(b) of Agenda Paper 11D from October 2016).
17. The existence of a covenant might increase the interest of the primary users in the inputs that determine whether a breach has occurred or could occur. In our example in paragraph 13 above of a covenant that requires the ratio of debt to

¹ 'Qualitative factors are considered as characteristics of a transaction, other event or condition that, if present, will make information about that transaction, other event or condition more likely to influence the economic decisions of the primary users of the entity's financial statements.' (paragraph 38 of Agenda Paper 11D from October 2016).

equity to be below a specified number, it would be reasonable to expect that users will have a greater interest in the total amount of debt and equity than they might otherwise do because of the existence of the covenant. Consequently, the entity might need to reduce the quantitative threshold against which materiality is assessed for both debt and equity to reflect the greater level of scrutiny that those amounts might attract.

18. We described in paragraphs 8-11 above that the materiality assessment of information about a covenant would be affected by the consequence and likelihood of a breach occurring. Similarly, an entity would need to consider the consequence and likelihood of a breach occurring when assessing the impact of the existence of a covenant on the materiality assessments of the inputs to the covenant trigger. The greater the consequences of a covenant breach, and the greater the likelihood of a breach occurring, the more likely it is that the existence of a covenant will affect primary users' views of the inputs to the covenant trigger. That is, the lower will be the quantitative threshold for materiality of the inputs to the covenant trigger.

Staff recommendation

19. We recommend that the Board provides, in the final *Practice Statement*, additional guidance, beyond that described in the 'Materiality Process' illustrated in Agenda Paper 11D from October 2016, on:
 - (a) how to assess the materiality of information about the existence and the terms of a covenant, or a covenant breach; and
 - (b) how the existence of a covenant affects the materiality assessment of the inputs to the covenant trigger.
20. That guidance will address respondents' concerns and provide a clear direction on an area which is often perceived as highly sensitive by preparers, users and regulators.

21. In particular, the Board should emphasise that in making both assessments an entity should consider:
- (a) the materiality of the *consequences* of the covenant breach on the entity’s financial position, financial performance and cash flows; and
 - (b) the *likelihood* of the breach occurring.

Questions for the Board

Question 1—additional guidance

Do you agree that the Board should include, in the final *Practice Statement*, specific guidance on:

- (a) how to assess the materiality of information about the existence and the terms of a covenant, or a covenant breach; and
- (b) how the existence of a covenant affects the materiality assessment of the inputs of the covenant trigger?

Question 2—what that guidance should be

Do you agree that the Board should emphasise, in the final *Practice Statement*, that in making both assessments (Question 1 (a) and (b)) an entity should consider:

- (a) the materiality of the *consequences* of the covenant breach on the entity’s financial position, financial performance and cash flows; and
- (b) the *likelihood* of the breach occurring?