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IFRS Viewpoint

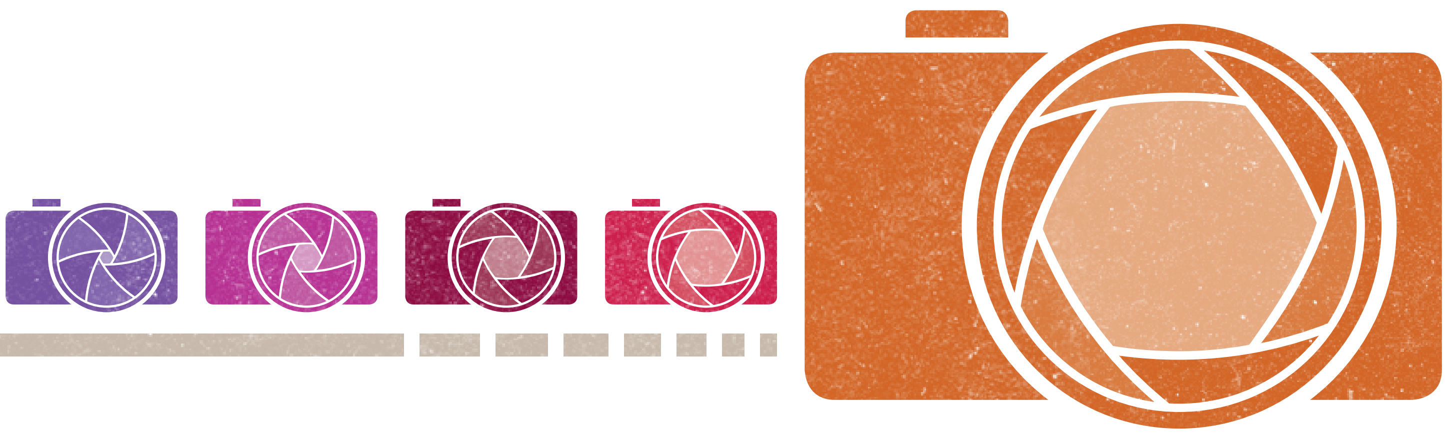
Classification of loans with covenants

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each issue will focus on an area where the Standards have proved difficult to apply or lack guidance. This issue considers how the existence of covenants can impact the presentation of debt on the balance sheet.

What's the issue?

Loan agreements often include covenants that, if breached by the borrower, permit the lender to demand repayment before the loan's normal maturity date. In response to a borrower's request, lenders may decide to voluntarily waive some or all of the rights they acquire as a result of a breach. This IFRS Viewpoint provides guidance on the classification of long-term loans payable as either current or non-current when covenants are present.

Relevant IFRSs
IAS 1 Presentation of Financial Statements
IAS 10 Events after the Reporting Period
IFRS 7 Financial Instruments: Disclosures



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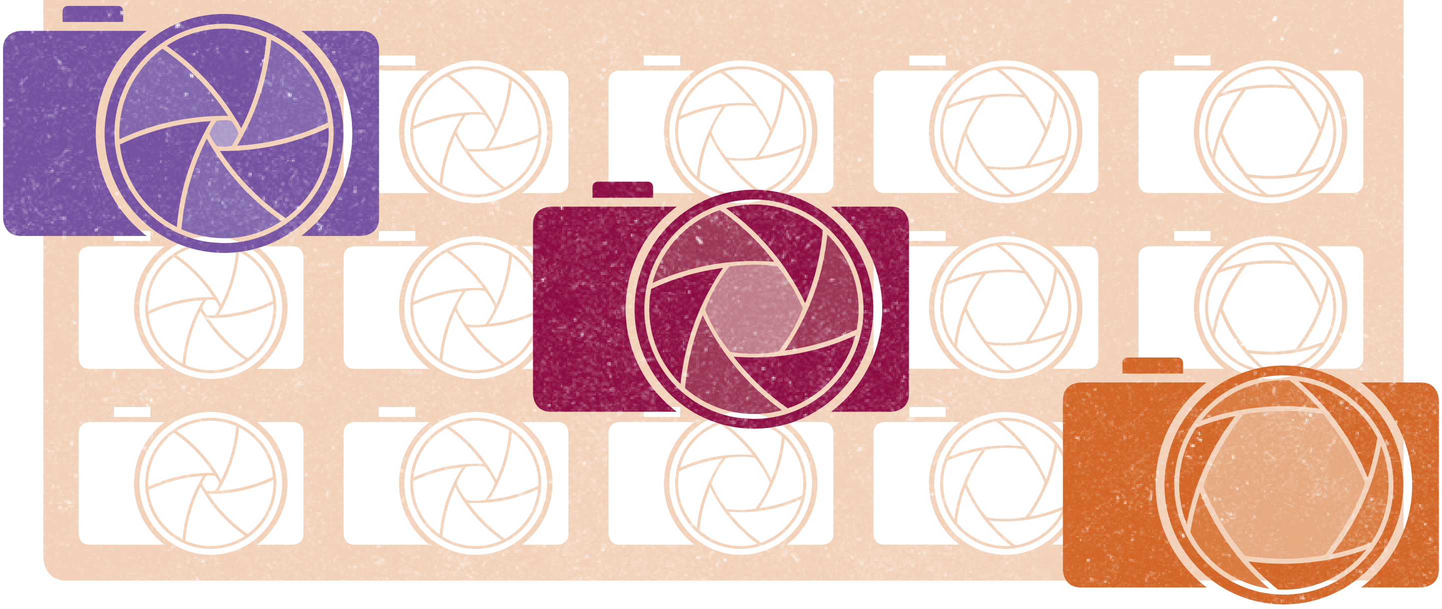
Our view

Classification of a long-term loan payable as either a current or non-current liability is based on the existing rights of the borrower and lender (the 'condition of the loan') at the reporting date:

- when a borrower has the right to defer settlement for at least 12 months beyond the reporting date, a loan is classified as non-current
- the anticipated outcome of future covenant tests (based on financial conditions existing after the end of the current reporting period) does not influence the classification of a loan at the reporting date
- when assessing the impact of waivers, it is important to consider both the timing of the waiver and how it affects the rights of the parties at the reporting date.

Our more detailed comments below assume that a breach of a borrowing covenant entitles the lender to require repayment on demand.



More analysis

Effect of a covenant breach on classification

Loan covenants can take many forms. A typical example requires a borrower to maintain one or more key financial ratios (such as interest cover or a debt-to-equity ratio) above or below a specified benchmark. When a borrower breaches a covenant on or before the reporting date, the loan should be classified as current if the borrower does not have the right to defer settlement for at least 12 months after the reporting date.

The assessment of whether a long-term loan should be classified as current or non-current is based on the condition of the loan at the reporting date. This means that:

- if a company breaches a covenant before the end of the reporting period and as a result does not have the right to defer payment for a period of at least 12 months following the reporting date, the loan is classified as current
- if a company breaches a covenant after the end of its reporting period but before the date of approval of its financial statements, the loan continues to be classified as non-current. This is an example of a non-adjusting event (see IAS 10) that must be disclosed in the financial statements
- when information comes to light after the end of a reporting period indicating that covenants have, in fact, been breached at period end, this is an example of an adjusting event and the loan is classified as current
- the anticipated outcome of future covenant tests (based on financial conditions existing after the end of the current reporting period) does not influence the classification of a loan at the reporting date. This is true even when the borrower believes it is likely that it will 'fail' the future tests
- whether or not a breach has been reported to the lender is irrelevant.

Practical insight

A convertible loan may allow the lender to elect to receive shares of the borrower in settlement of the amount owing in advance of the loan's normal maturity date. Even when exercisable immediately, these rights will not affect the loan's classification.

Covenant waivers

A lender may choose to waive the right to demand repayment it acquires as a result of a borrower's covenant breach. For example, a waiver may:

- unconditionally 'forgive' the past breach so that the lender no longer has (and never will have) a right to demand repayment as a result of that breach
- document the lender's agreement not to demand repayment for a fixed period of time after which it will decide whether to require settlement
- be conditional on the borrower satisfying new or additional covenants or tests specified by the lender.

When assessing the impact of waivers on the related loan's classification, it is important to consider both the timing of the waiver and how it affects the rights of the parties at the reporting date.

Timing

A waiver can only result in a loan being classified as non-current if it is obtained on or before the reporting date.

If a lender provides a waiver after the reporting date, the borrower classifies the liability as current because at the reporting date it did not have the right to defer settlement for at least the next 12 months. The grant of the waiver is disclosed as a non-adjusting event if obtained before the date of approval of the financial statements.

Effect on rights of parties

A timely waiver will result in a loan being classified as non-current only if the lender no longer has a right to demand repayment for a period of at least 12 months from the reporting date.

A lender may agree to waive the repayment rights it obtained as a result of the breach, but insert an additional covenant test within 12 months of the reporting date. Assuming the future covenant test is based on the financial condition of the borrower at a date after the reporting period end, the loan will once again be classified as non-current. This is because the classification is not affected by the existence or expected outcome of future covenant tests.

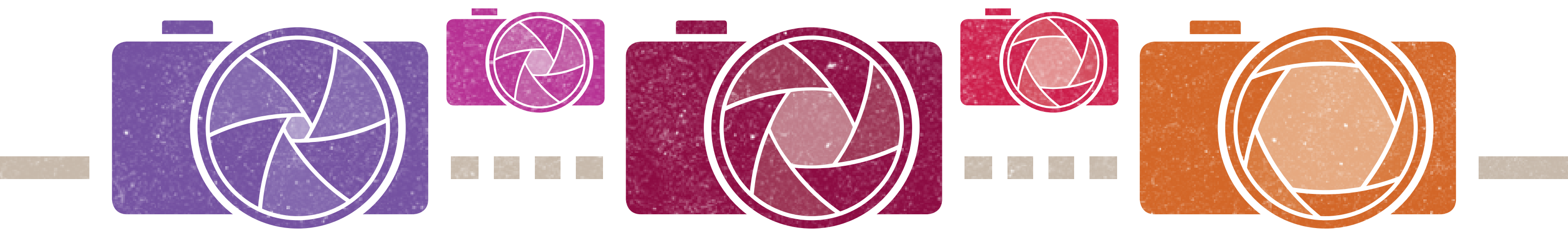
Uncertainty as to whether a covenant has been breached

The terms of loan covenants are sometimes expressed qualitatively, or in some other way that requires interpretation or judgement. For example, a covenant may refer to 'a material adverse change in the circumstances of the borrower'. Determining whether or not a breach has occurred at the reporting date may then require clarification from the lender or legal advice. However, the mere existence of such a covenant does not automatically lead to the loan being classified as current. The borrower may still have the right to defer settlement for at least 12 months after the reporting period.

In some cases, the language used to describe a covenant suggests the lender has absolute discretion in deciding whether a breach has occurred. Such covenants are similar in substance to a demand feature and the related loans should be reported as current liabilities.

This view was confirmed by the IFRIC in September 2010 in a so-called 'agenda decision'. The IFRIC considered term loan arrangements with features allowing lenders to call the loan at any time and for any reason. The question asked was how such terms would impact a company's classification of the loan as either current or non-current under IAS 1.

The IFRIC's view was that classification of the loan as current or non-current should be determined based on the rights and obligations of the lender and the borrower on the relevant date. When a condition allows the lender to demand repayment at any time in its sole discretion, the borrower does not have the right to defer settlement for at least 12 months.



Disclosure

When a breach occurs during the period and the breach is not remedied nor the loan renegotiated before the reporting date, IFRS 7 requires the following disclosures (where the information is considered to be material to the financial statements):

- details of the breach
- the carrying amount of the related loan
- whether the breach was remedied or the terms of the loan renegotiated before the financial statements were authorised for issue.

When the breach occurs after the reporting date but before the financial statements are authorised for issue, this is a non-adjusting event and the loan will continue to be classified as non-current. Details of the breach will need to be disclosed together with an estimate of its financial effect, or a statement that such an estimate cannot be made.

Covenant breaches – the bigger picture

The breach of a loan covenant may indicate the existence of wider problems with a borrower's overall financial health. While all breaches may cause concern, when a breach remains unremedied and the lender has obtained a right to demand accelerated repayment of the related loan, this may impact a borrower's ability to continue as a going concern.

A borrower considers the impact of covenant breaches and other relevant factors and assesses whether there are material uncertainties over its ability to continue as a going concern. Even though a breach (or other relevant event) may not occur until after the reporting date, it must still be considered. If material uncertainties are found to exist, they must be disclosed.

Occasionally, the impact of a covenant breach is so severe that the going concern assumption is no longer appropriate and management has little choice but to liquidate or cease operations. When this happens, a company is required to prepare its financial statements on a basis other than going concern. Selecting an appropriate basis will require the exercise of professional judgement and the basis selected will need to be disclosed.

Practice tip – timing is everything!

You are the CFO of a company with a calendar year-end and a long-term bank loan with financial covenants. As with many such loans, the bank requires you to assess the covenants at the end of each quarter, and to report to the bank within the following 30 days. If the covenants are breached, the loan is repayable immediately.

In this very common situation, companies face a challenge. By the time you complete your end of year assessment of covenant compliance, it might be too late to obtain a pre-year end waiver (assuming one is needed) as the waiver must be received before period end! So what can you do to avoid showing the loan as a current liability in your year-end financial statements?

1. Timing is everything – monitor your covenants closely throughout the year. If early December arrives and you think there is a possibility that covenants may be breached at year-end, start speaking with your banker immediately to maximise the chances of obtaining a waiver pre-year end if necessary;
2. Plan ahead – when negotiating long-term loans, see if your bank is willing to consider off-quarter covenant testing (e.g. 28 February, 31 May, 31 August, and 30 November).

Examples

Example 1 – covenant test within 12 months

Company A has a long-term bank loan which is subject to certain financial covenants. The loan agreement states that these covenants will be assessed at the end of each quarter, and reported to the bank within the following 30 days. If the covenants are breached, the loan will be repayable immediately. At its year-end, Company A determines that it is not in breach of the covenant.

Analysis

Company A should classify the loan as non-current at the reporting date. The fact that Company A must assess its compliance with the covenants within the next 12 months does not change the condition of the loan at the reporting date.

Example 2 – probable future covenant breach

Facts are as in Example 1 except that Company A believes it is likely that the loan covenants will be breached in the following quarter.

Analysis

Company A should still classify the loan as non-current at the reporting date. The fact that a future breach is anticipated does not change the condition of the loan at the reporting date.

Example 3 – covenant breach and waiver

Facts are as in Example 1 except that Company A is found to have breached a covenant before the reporting date. As Company A had anticipated the breach and opened discussions with its bank about the breach several weeks earlier, it was successful in obtaining a waiver before the reporting date. The terms of the waiver provide Company A with a period of grace ending more than 12 months after the reporting date within which it can rectify the breach, and during this time the bank cannot demand repayment as a result of that breach.

Analysis

Company A should classify the loan as non-current in its year-end financial statements because it had obtained an appropriate waiver in respect of the breach before the reporting date. This is the case even if the conditions that led to the breach are likely to persist with the effect that Company A expects to fail a future covenant test within the next 12 months. If future tests are based on conditions in existence on future dates, they do not affect the loan's classification at the reporting date (see Example 5 where this principle is explored further).

Example 4 – covenant breach and limited period waiver

Facts are as in Example 3 except that the terms of the waiver specify that the bank cannot demand repayment as a result of the breach during the next three months and will immediately enter into discussions with Company A in respect of refinancing the loan. After three months the bank has the right to demand immediate repayment.

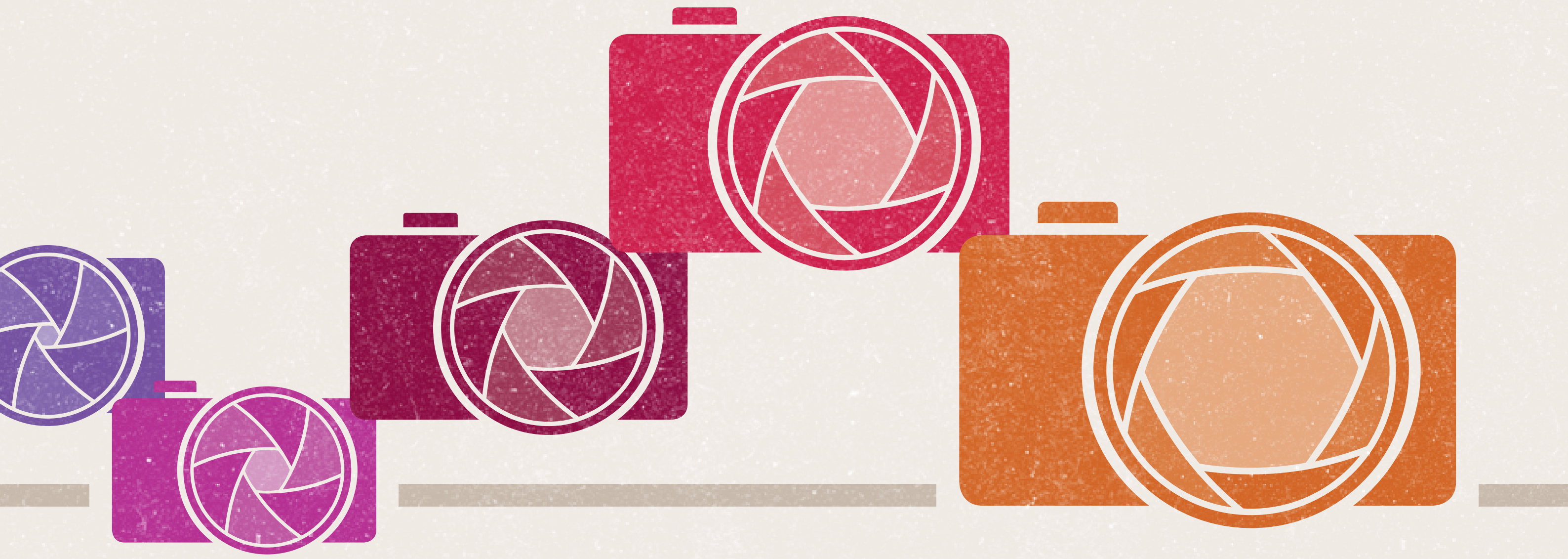
Analysis
Company A should classify the loan as current at the reporting date. The covenant has been breached at the reporting date and the bank has deferred a decision regarding the repayment of the loan for a period of less than 12 months from the reporting date.

Example 5 – covenant breach, waiver, and insertion of new covenant test

Facts are as in Example 3 except that the terms of the waiver also subject Company A to an additional one-time covenant test to be performed sixty days after the reporting date.

Analysis
In general, and consistent with the preceding examples, a loan's classification is assessed based on a 'snapshot' of conditions existing at the reporting date. As a result, classification is not affected by the existence or expected outcome of future covenant tests. It follows that the insertion of an additional covenant test within the next 12-months period as part of the waiver does not ordinarily prevent classification of the loan as non-current at the reporting date.

These general principles might be tested, however, in situations where there is no genuine possibility that Company A will succeed in passing the additional test in 60 days' time. In such circumstances, the substance of the arrangement is the same as a limited period waiver (60 days in this case) and the loan should be classified as current. However, IAS 1 does not provide detailed guidance on this matter and professional judgement will be required based on specific facts and circumstances.



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