Grant Thornton

Technical Accounting Alert

Classification of loans with covenants as current or non-current Introduction

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. Such covenants may, for example, require the borrower to maintain one or more key financial ratios (such as interest cover or a debt to equity ratio) above or below a stated benchmark level.

This alert provides guidance on the current or non-current classification of loans payable that are subject to borrowing covenants.

Relevant standards

References are made in this alert to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	**Australian equivalent standard**
IAS 1 Presentation of Financial Statements	AASB 101 Presentation of Financial Statements
IAS 10 Events after the Balance Sheet Date	AASB 110 Events after the Balance Sheet Date
IFRS 7 Financial Instruments: Disclosures	AASB 7 Financial instruments: Disclosures

Guidance

A borrower should classify a loan payable as a current liability when it does not have an unconditional right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)). The borrower should assess whether such an unconditional right exists based on the condition of the loan at the end of the reporting period (the reporting date). The guidance below has been written assuming that a breach of a borrowing covenant entitles the lender to require repayment on demand.

Effect of a covenant breach on classification

Where a borrower has breached a loan covenant on or before the reporting date, it should classify the loan as current (IAS 1.74). The borrower does not have an unconditional right to defer settlement for at least twelve months after that date.

The assessment of whether or not an entity has breached its loan covenants is based on facts and circumstances at the reporting date. Accordingly:

- Classification is based on whether the borrower is in breach of the covenant at the reporting period end, regardless of whether the breach has been reported to the lender at that date. For example, where a breach of a covenant is reported to the lender after the reporting period end but the assessment is based on the financial condition of the borrower at the reporting date, this will result in classification of the loan as current.

- If an entity breaches a covenant after the end of its reporting period but before the date of approval of its financial statements, this is a non-adjusting event in accordance with IAS 10. This matter should be disclosed in accordance with that Standard (along with the matters referred to IAS 1.76). Information received that provides evidence of the entity's financial condition at the period end and indicates a breach of a covenant that is assessed based on period end conditions is an adjusting event.

- A covenant test within the following twelve months based on the financial conditions after the end of the reporting period does not result in current classification of the loan at the reporting date. This assessment relates to the future condition of the loan. This is the case even if the borrower believes that it is likely that it will 'fail' the future covenant test.

- Further, a covenant test within the following twelve months based on the financial condition of the borrower at a future date does not result in current classification even if at the reporting date the borrower's financial status would result in a breach if the test were based on conditions at that date.

Covenant waivers

A lender may however grant a waiver of its right to demand repayment following a covenant breach in order to allow the borrower time to rectify the breach. The terms and conditions attached to waivers, along with their timing, should be carefully assessed to determine the effect on loan classification. For example, a waiver may:

- defer the lender's demand rights to a later date at which time the lender can decide whether to require settlement

- be an unconditional 'forgiveness' of the past breach such that the lender no longer has a right to demand repayment and will have no automatic right in future

- be conditional on future rectification actions by the lender which are in effect new or additional covenants.

Where the entity obtains a waiver in respect of the breach **before** the reporting date the loan is classified as non-current if the effect is to defer the lender's right to demand repayment for a period of at least 12 months from the reporting date (IAS 1.75). In other cases, a lender may agree to waive a covenant breach before the end of the reporting period, but require another test within 12 months of the reporting date. As a result of this type of waiver, the past covenant breach in effect no longer exists. As the future covenant test is based on the financial condition of the borrower at a date after the reporting period, the loan should be classified as non-current. This is consistent with our guidance above on covenant tests within twelve months.

If the lender provides a waiver **after** the reporting date, the borrower classifies the liability as current because at the reporting date it did not have an unconditional right to defer settlement for at least twelve months after the reporting date (IAS 1.74). The grant of the waiver is disclosed as a non-adjusting event (IAS 1.76(c)).

Uncertainty as to whether a covenant has been breached

It is not appropriate to conclude without further analysis that current classification is required simply because a covenant is expressed in qualitative terms and not (for example) as a quantified financial measure or formula. The terms of loan covenants are sometimes expressed in a way that requires interpretation or judgement. For example, a covenant may refer to 'a material adverse change in the circumstances of the borrower'. The determination of whether or not a breach has occurred at the reporting date may then require clarification from the lender or legal advice. However, the covenant does not of itself imply that the borrower does not have an unconditional right to defer settlement for at least twelve months after the reporting period.

In some cases, the terms of a covenant may suggest that the lender has absolute discretion to judge whether a breach has occurred. In this situation, the substance of the covenant is that of a demand feature with the effect that current classification is appropriate.

Disclosure

IFRS 7 Financial Instruments: Disclosures requires the following disclosures in respect of breaches of loan covenants during the period (unless the breaches were remedied or the terms of the loan renegotiated on or before the reporting date):

- details of the breaches;

- the carrying amount of the loans concerned; and

- whether the breach was rectified or the terms of the loan renegotiated before the financial statements were authorised for issue (IFRS 7.18-19).

Where the borrower breaches a loan covenant after the reporting period and before the date when the financial statements are authorised for issue, this will be treated as a non-adjusting event and the loan will continue to be classified as non current. The breach would be disclosed in accordance with IAS 10.21.

Breaches of loan covenants that are not rectified prior to the date the financial statements are authorised for issue will often have implications for the appropriateness of the going concern assumption which will need to be carefully considered. A detailed discussion of going concern issues is outside the scope of this hot topic. However, it should be noted that:

- Breach of a loan covenant is likely to be associated with wider problems in the borrower's financial performance and position.

- The possible effect of the breach in accelerating the required repayment of a loan may of itself give rise to uncertainties as to the ability of the borrower to continue as a going concern, in addition to the wider problems referred to above.

- If the impact of a post-reporting date covenant breach (combined with other factors as applicable) is that the going concern assumption is no longer appropriate, the effect is so pervasive that IAS 10 requires that the financial statements are prepared on a non-going concern basis (described in IAS 10.15 as 'a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognized within the original basis of accounting').

- IAS 1.25 specifies disclosures concerning material uncertainties as to an entity's ability to continue as a going concern. Information received after the reporting date (including a covenant breach) is relevant in assessing whether these disclosures are required (IAS 10.16).

Examples

Example 1 - covenant test within 12 months
Entity 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 a month of the end of each quarter. If the covenants are breached at this time, the loan will be repayable immediately. At the year end, Entity A determines that it is not in breach of the covenant.

Analysis
Entity A should classify the loan as non current at the reporting date. The fact that Entity A must assess compliance with the covenants within the next twelve months does not change the condition of the loan at the reporting date. This assessment relates to future conditions.

Example 2 - probable future covenant breach
Facts as in example 1 except Entity A believes that it is likely that there will be a breach in the following quarter.

Analysis
Entity A should classify the loan as non current at the reporting date. The fact a future breach is likely does not change the condition of the loan at the reporting date.

Example 3 - covenant breach and waiver
Facts are as in example 1. Prior to the reporting date, Entity A breaches a covenant and obtains a waiver from the bank. The terms of the waiver specify that Entity A has twelve months from the reporting date in which to rectify the breach and the bank cannot demand repayment as a result of the breach during this period. Entity A expects to rectify the covenant breach by raising additional equity capital by means of a rights issue to existing shareholders. The rights issue has been fully subscribed.

Analysis
Classify the loan as non current at the reporting date, Entity A had obtained an appropriate waiver in respect of the breach before the reporting date and it is within its power to rectify the breach within the waiver period.

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 in which period it will enter into discussions with Entity A in respect of a refinancing of the loan.

Analysis
Entity A should classify the loan as current at the reporting date. The loan was in breach at the reporting date and the waiver does not excuse the breach. The bank has deferred a decision regarding the repayment of the loan for a period of less than twelve months from the reporting date.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au