IAS 1: implications for companies facing a potential financial covenant breach

In this briefing, Kathrine Meloni and Samyuktha Rajagopal consider the implications of IAS 1 for companies that need to address potential breaches of financial covenants under their loan documentation.

Financial covenants in loan documentation are typically tested at the end of a quarterly or half-yearly accounting period, by reference to financial statements drawn up as at the testing date. These accounts cannot be finalised until the accounting period has closed, and so will generally not be available until after the end of the period. Loan documents therefore customarily provide that a compliance certificate, evidencing the borrowing group's compliance with the financial covenant provisions is delivered to its creditors together with its annual or interim financial statements. The deadline for delivering the financial statements can vary, but it is always a date falling after the end of the reporting period and the date on which the financial covenants are tested.

It follows that if a company is facing financial distress, it may not have the factual information (the finalised accounts) on the date its financial covenants are tested, to establish definitively whether or not it has complied with its covenants. If it needs to seek a waiver or reset of the financial covenants, this will most likely become apparent in the period after the test date and prior to the date for delivery of the financial statements and relevant compliance certificate.

Companies should be aware that this time lag between the covenant test date, the discovery of a breach and any subsequent negotiation with creditors in relation to the breach has implications for the company under para 74 of International Accounting Standards 1 (IAS 1). This provides:

"**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 12 months after that date"* **(emphasis added)**

The effect of this provision is that companies whose accounts are prepared in accordance with IAS 1 (which would include listed companies in the UK) must classify liabilities in their accounts as "current" if, as at the reporting date, they do not have the right to defer payment for twelve months or more. This would often be the case under most loan documentation if a covenant breach is discovered after the testing date and pending the relevant creditors' agreement to waive the breach. Crucially, even if the company is able to obtain a waiver of a covenant breach from its creditors after the reporting/testing date and before the issuance of the relevant financial statements, IAS 1 would still require the liability to be classed as "current".

Disclosing a group's corporate loan facility (for example) as a current liability rather than a non-current liability could have significant adverse consequences. For example, commercial counterparties may infer that the company is facing a liquidity issue. While a company should typically be able to disclose a subsequent waiver as a material non-adjusting event in the notes to its balance sheet in accordance with IAS10, ideally, borrowers will wish to address the issue before the reporting date.

This issue is often managed in practice by agreeing and documenting a short term covenant deferral. Broadly, this involves deleting the original financial covenant test and test date in the loan agreement with an alternative test at a new deferred test date. Say, for example, a loan agreement provided for a covenant to be tested over a 12-month period ending on 30 June and before that date, the company considers that a covenant breach is likely to occur at the 30 June test date. If, at that point, the original covenant were deleted and replaced with a covenant to be tested over a 15 month basis on 30 September, the liability would not need to be classified as current in the 30 June accounts as the reporting period (for the purposes of the revised covenant) would be still open. Companies could, of course also look to agree a covenant reset or waiver, although this may not be an option where there is limited time for a negotiation ahead of the test date or if a broader restructuring is required.

The mechanism described above, addresses an accounting rather than a legal issue and as such, requires the company's accountants' sign-off. This additional downside of a potential covenant breach – which in some circumstances, could accelerate a deterioration in the group's financial condition – provides further impetus for companies in financial distress to monitor their covenants closely, look ahead to future testing dates and, where appropriate, seek to obtain a waiver or deferral from lenders as early as possible.

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