

Accounting for breaches of debt covenants

The impact of COVID-19 can result in a significant deterioration in operating results and financial positions which may in turn cause breaches of debt covenants or trigger subjective covenant clauses in loan agreements. These could render the related debt repayable on demand before the contractual maturity date, resulting in the borrowing being classified as a current liability rather than non-current liability at the reporting date.

When loan agreements include subjective covenant clauses – e.g. ‘material adverse change’ clauses – State entities will need to exercise judgement in determining whether such clauses are breached.

Even if a breach has not occurred by the reporting date, State entities will need to assess their ability to maintain compliance with debt covenants, in order to decide whether to renegotiate the covenant clauses with lenders. Such negotiations can lead to a waiver of the breach or loan agreement variation from the lending authority.

A couple of key considerations arise where a breach of loan covenant occurs:

1. *If a waiver is provided after 30 June, because the breach may not be definitely known until the 30 June statements are drafted, will a State entity still be able to show the portion of the debt that is beyond 12 months as non-current?*

If the waiver is provided **after** 30 June, the debt will need to be classified as **current**.

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 (AASB 101.74). The grant of the waiver should be disclosed as a non-adjusting subsequent event (AASB 101.76(c)).

If a waiver is provided **before** 30 June the client can continue to disclose the applicable portion of the debt as **non-current**.

Where a State 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 (AASB 101.75). 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.

State entities would probably need to make disclosure, similar to that below.

Breaches of loan covenants – classification of loan as “non-current” at reporting date

Some of the Entity’s loan agreements are subject to covenant clauses, whereby the Entity is required to meet certain key financial ratios. The Entity did not fulfil the debt/equity ratio as required in the contract for a credit line of \$[], of which the Entity has currently drawn an amount of \$[]. Due to this breach of the covenant clause, the lender is contractually entitled to request for immediate repayment of the outstanding loan amount of \$[]. However, prior to the end of the financial year, the lender has agreed to a period of grace ending more than 12 months after the reporting date within which the Entity can rectify the breach, and during this time the lender cannot demand repayment as a result of that breach. The outstanding balance is presented as a non-current liability as at 30 June 2020.

2. *What should be the duration of the waiver?*

The waiver needs to enable a State entity to maintain an unconditional right to defer settlement for at least 12 months. This derives from the requirement for classifying a liability as current, in this case for debt, where the 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 (AASB 101.69(d)).

Therefore, a State entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment. (AASB 101.75)