How do external events impact current and non-current classification of debt?

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Deteriorating conditions arising from external events may trigger breaches of debt covenants or material adverse change clauses. Such breaches could cause debt to be classified as a current liability – i.e. if it becomes repayable on demand.

What's the issue?

External events – e.g. a natural disaster, geopolitical affairs or a pandemic – may cause economic uncertainty and have adverse effects on a company's operating results and financial position. In turn, this may cause breaches of debt covenants or trigger subjective covenant clauses, which could render the related debt repayable on demand before the contractual maturity date. This means that the debt would be classified as current rather than non-current at the reporting date.

When loan agreements include subjective covenant clauses – e.g. 'material adverse change' clauses – companies will need to exercise judgement in determining whether those subjective clauses are breached.

Even if a breach has not occurred by the reporting date, companies will need to assess their ability to maintain compliance with debt covenants, in order to decide whether to renegotiate the covenant clauses with lenders.

Getting into more detail

How debt covenants affect the classification of debt

Under IFRS® Standards, when a company breaches a provision of a long-term loan arrangement on or before the reporting date such that the liability becomes repayable on demand, it classifies the liability as current. This is because the company does not have an unconditional right to defer its settlement for at least 12 months after that date. *[IAS 1.74, Insights 3.1.40.90]*

However, if by the reporting date the company obtains from the lender an agreement to provide a grace period ending at least 12 months after the reporting date, then the liability is classified as non-current. *[IAS 1.75]*

If the company obtains this agreement after the reporting date, then this is treated as a non-adjusting event. This means that the company is required to classify the liability, which is now repayable on demand as a result of the breach, as current at the reporting date. *[IAS 1.76]*

Greater challenges in complying with debt covenants

In times of economic uncertainty, it is likely that companies will find it more difficult to comply with debt covenants. The following circumstances, for example, either individually or collectively, could cause a significant deterioration of financial performance and financial ratios, which may in turn lead to a breach of debt covenants:

– a decrease in customer demand;

– a disruption in production or supply;

- an impairment loss caused by doubts about the recoverability of financial or **non-financial** assets that lead to impairment losses;
- a decrease in the **market price of investments** held; or
- an increase in the provision for certain obligations – e.g. those arising from **onerous contracts** or **restructuring plans**.

If a breach of covenant results in the debt becoming repayable before the contractual maturity date, then management would need to consider the breach as part of a broader assessment in determining the company's ability to continue as a **going concern**.

When a company breaches a debt covenant relating to borrowings recognised during and at the end of the reporting period, IFRS 7 *Financial Instruments: Disclosures* requires specific disclosures in the financial statements. *[IFRS 7.18–19]*

Evaluation of subjective covenant clauses

Some loan agreements may include covenant clauses that are not based on financial ratios, making the determination of whether a breach occurs more subjective. Some clauses could trigger an acceleration of repayment if, for example, the company's share price falls or the value of assets provided as collateral decreases. Other clauses may be less definitive – e.g. a loan agreement may give the lender the right to demand immediate repayment when the borrower experiences 'significant financial difficulties'. However, this term may not be clearly defined in the loan agreement and companies will need to exercise judgement to determine whether a breach occurs on or before the reporting date.

Subsequent events

Any refinancings, amendments or waivers that are agreed after the reporting date are not considered in determining the classification of debt, but are disclosed as non-adjusting events. *[Insights 2.9.40.10]*

Interim reporting considerations

Companies should consider the classification of assets and liabilities as current or non-current at the interim reporting date. For example, debt for which provisions are breached at the interim reporting date such that the liability becomes repayable on demand would need to be classified as current, unless the company obtained a waiver before the interim reporting date.

Actions for management

To assess whether debt subject to covenant clauses needs to be classified as current or non-current at the reporting date, management may need to do the following.

- Review covenant clauses in loan agreements and assess whether a breach has occurred or is likely to occur at the reporting date.
- Assess whether it is necessary to obtain a waiver or grace period from the lender.
- Evaluate the company's ability to maintain compliance with debt covenants and consider whether a renegotiation of covenant clauses with lenders is necessary.
- Provide the disclosures required under IFRS Standards.

References to 'Insights' mean our publication **Insights into IFRS®**

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