Briefing note

International Financial Reporting Standards (IFRS)

The Impact of IFRS - Borrower/Lender Relationships

This was the topic of a joint Association of Corporate Treasurers/Loan Market Association Seminar in November 2004. The seminar followed a joint ACT/LMA statement on the issue. The statement and the papers presented to the seminar are available at www.treasurers.org/technical/ifrs.cfm.

Few companies are likely to have serious issues with financial covenants on first time adoption of International Financial Reporting Standards (IFRS), but all do need to check their own position. The position of any company will be peculiar to itself, its circumstances and its particular loan agreements.

This briefing note sets out certain matters to have in mind in considering how IFRS adoption affects financial covenants in a company's loan agreements.

Financial covenants in company loan agreements with banks

1. Preliminary: Waiver/agreed variation in terms; extension of grace-periods; cross-default

1.1. A *waiver* of default by a bank is generally made after the event of a default which is eventually rectified by a borrower, or to cater, whether in advance or after the event, for a one-off breach which is expected to be temporary.

1.2. A *variation in terms* agreed between banks and a borrower changes the terms of the agreement for the remainder of its life (or for a period defined in the variation). What would otherwise be a continuing default needs an agreed variation in continuing terms, rather than a waiver. Where a variation in terms is agreed only after a default, a waiver for the actual default is still necessary (unless the variation takes retrospective effect).

1.3. A *grace period* is time allowed for rectification (after a failure to comply with a covenant occurs) before default is triggered, and may apply to some covenants.

1.4. Careful consideration of other agreements is necessary to check if a breach of a financial covenant, even if waived, triggers the *cross-default* provisions of any other agreement. The borrower will want to establish that any new granting of a grace-period or an extension of an originally provided grace period or the granting of a "waiver" avoids cross-default to other loan agreements (which other defaults may trigger further default of the original agreement). Cascading defaults can make difficulties unmanageable.

2. Loan agreements containing a "frozen GAAP" provision

2.1. In a typical *"frozen GAAP" provision*, the borrower undertakes to ensure that either (i) all financial statements provided to the lenders apply the same Generally Accepted Accounting Principles (GAAP) as were used in the financial statements delivered at or prior to signing of the loan agreement or, (ii) if there is a change in the GAAP used (such as the adoption of IFRS will entail), to identify for the banks the changes necessary for the financial statements to reflect the original GAAP, and to provide them with sufficient information to enable them to test compliance with any financial covenants.

2.2. Where a loan agreement contains a frozen GAAP provision, the company will not be at risk of going into default merely by adopting IFRS – unless it fails to deliver required information based on the frozen GAAP in due time.

2.3. Under a typical frozen GAAP provision, the company will be obliged to go on supplying financial information on a frozen GAAP basis and making calculations for covenant purposes based on frozen GAAP figures.

2.4. The company will probably desire eventually to negotiate new covenants adapted to its IFRS compliant reports so that it can stop keeping frozen GAAP information. This is a matter of convenience and also of cost. Time is probably available to negotiate suitable amendments.

2.5. It is important to ensure that frozen GAAP information required is available within the time period stipulated in the loan documentation. Failure to provide the information in proper form in due time is itself usually a breach of covenant, which, assuming it is eventually rectified, would require a waiver (but this may not avoid cross-default to other loan agreements).

3. Loan agreements where there is no “frozen GAAP” provision

3.1. Loan documentation/default etc.

3.1.1. Where any one of a company's loan agreements with financial covenants lacks a frozen GAAP clause, the requirement will usually be to provide financial reports in accordance with GAAP as it changes from time to time. The financial covenants will then be tested using information taken from IFRS compliant reports. This is expected to apply to only a few companies as most agreements provide for frozen GAAP.

3.1.2. In these few cases, if it is likely that calculations based on IFRS compliant accounts may result in breach of covenants, it will be necessary to negotiate (in advance) a variation in the terms of the agreement with new covenants adapted to the new reporting standards. (See also 3.5, Ongoing monitoring, below.)

Depending on the language of the loan agreement, a company is likely to be in default if and when it publishes IFRS accounts on the basis of which it fails to comply with any financial covenant (if not before).

3.1.3. Once the company knows that it will (or is likely to) be in that position, it may, depending on the loan documentation’s specific wording, already be in breach. Such breach could also trigger cross default to other agreements (according to their wordings) - which could itself be a new cause of breach of the first agreement. Early action to agree a variation in terms is necessary.

3.2. “Potential events of default” and “material adverse change” (MAC) clauses

3.2.1. Some loan agreements may define potential events of default which refer to defaults which may be triggered in the future (commonly "by the passage of time or the giving of notice"). If such potential events of default exist they may, according to the precise wording, act to remove the banks' obligation to make new advances or to roll-over existing drawings under the loan agreement. Careful consideration of such a clause is necessary.

3.2.2. Loan agreements may contain an MAC clause which comes into operation when there is a material adverse change in the borrower's ability to perform its obligations under the agreement – including compliance with covenants. According to the exact wording, such a clause could be triggered by the coming into effect of an obligation to report in conformity with IFRS if it is expected that under IFRS based calculations the company may be in default of a covenant. Careful attention to any MAC clause is necessary.

3.3. "Going concern" basis of accounts

3.3.1. In the rare cases considered in 3.1, it may have to be considered if the accounts of such a company can be produced on a going concern basis if publication of those accounts will trigger default in its (bank) financing.

3.4. Announceable event

3.4.1. It has to be considered if a listed company expecting to be in breach of covenant as considered in 3.1 has or will have an obligation to make an announcement of its circumstances to the market under listing rules of the United Kingdom Listing Authority (or equivalent overseas listing rules for non-UK-listed companies). This is because banks' rights after default to refuse new advances or to accelerate repayment of drawings can threaten a company's liquidity and its ability to meet obligations as they fall due.

The UK Listing Rules provide some exemptions from disclosure obligations. These may or may not be available. An example of an exemption from immediate disclosure is regarding matters under negotiation where release of information may damage the outcome of the negotiations. Once a breach of covenant has occurred, however, that is not a matter of negotiation (although what to do about it may be).

3.4.2. It should be noted, however, that the continuing disclosure obligations of listed companies are expected to change during 2005, as a result of the implementation in the UK of the Market Abuse Directive and consequent amendment of the Listing Rules.

3.5. Ongoing monitoring

3.5.1. Borrowers need to monitor compliance (both actual and forecast) with covenants of all kinds, not merely financial covenants. They need to recognise that some covenants apply at particular times or on the happening of particular events (for example on new or rolled-over advances under agreements), and some apply at all times.

3.5.2. Best practice is also to model the impacts on covenants of plans or scenarios considered in the company's long-term planning and strategy development. It must not be overlooked that loan covenants are likely to include repetition from time to time of certain warranties given at the time of the original loan agreement, or repetition of warranties may be a condition of new drawings and roll-overs.

4. Other documents

4.1. Companies need to ensure that no obligations under their articles of association (such as borrowing limits), debt securities (including convertibles, debenture stock and high yield bonds) or in other contracts or, in regulated businesses, under relevant regulations or operating licences, will be affected by a change to IFRS compliant reporting and take any necessary actions – including in respect of going concern and disclosure obligations.

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