



BDO Dunwoody LLP
Chartered Accountants
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When Should You Reclassify Your Long-term Debt as Current?

A summary of CICA Handbook EIC-59: Long-term Debt with Covenant Violations and EIC-122: Balance Sheet Classification of Callable Debt Obligations and Debt Obligations Expected to be Refinanced

Introduction

Generally accepted accounting principles require liabilities to be presented as current or long-term based on their underlying substance. In certain situations long-term debt may become payable within one year thereby requiring it to be reclassified as a current liability. This publication summarizes those situations so that you can attempt to take appropriate action, on a timely basis, to prevent the reclassification of long-term debt as current.

When does long-term debt shown on your balance sheet need to be reclassified as current?

1. When measurable debt covenants have been violated at the balance sheet date;
2. When measurable debt covenants have not been violated at the balance sheet date, but likely will be in the upcoming year because of unfavourable circumstances such as a claim for bankruptcy;
3. When the debt is a "demand loan"; or
4. When the debt is expected to come due within one year from the balance sheet date.

If any of these situations exist, the long-term debt must be reclassified as current unless certain conditions are met. These conditions are described below along with specific recommendations to ensure that the debt remains long-term on the balance sheet. Please note that these recommendations will have to be followed for the current and all subsequent reporting periods (including interim periods) for which financial statements are presented in order to continue classifying the debt as long-term.

Please note that situations #3 and #4 above are only effective for periods beginning on or after January 1, 2002 (i.e., December 31st, 2002 year ends, short year ends, and interim periods falling in 2002). The other situations are already in effect. Application of these standards will impact the current and future periods. Prior periods are not restated.

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1. Covenant Violations at the Balance Sheet Date

To determine if long-term debt needs to be reclassified as current, you need to look at the measurable debt covenants (not “subjective” covenants, such as the need to maintain “strong management”) at the balance sheet date. Note that measurable covenants are those for which compliance can be objectively determined. Such covenants include, for example, meeting certain financial ratios, or making property tax payments.

If measurable debt covenants have been violated at the balance sheet date, there are some options available to you. Most require some cooperation from your creditor and/or require you to take action on a timely basis. We suggest investigating the options below to determine which one will work for you.

What Can You Do to Ensure that the Debt Remains Long-term on Your Balance Sheet?	What Documentation Should You Provide to Your Auditor/ Public Accountant?	What Disclosure is Required in Your Financial Statements? <i>(See Appendix A for sample note disclosures).</i>
<p>If the debt agreement contains a grace period to cure the violation, try to put contractual arrangements in place to cure the violation. (Note, these contractual arrangements must be made with the creditor and generally contain severe economic consequences if breached.)</p> <p>AND</p> <p>Depending on which of the original or modified covenants that will be in effect within one year of the balance sheet date, ensure that it is not likely that you will violate the original/modified covenants at that time.</p>	<p>A copy of the debt agreement containing the grace period.</p> <p>Written documentation of the contractual arrangements made.</p> <p>Documentation supporting the fact that the original/modified covenants will likely not be violated within one year of the balance sheet date. Such documentation could include cash flow projections/budgets or contracts in place (if any) regarding new product lines, sales contracts, etc.</p>	<p>Ensure your financial statements have adequate note disclosure about the current violation and the substance of the contractual arrangements made in the subsequent grace period.</p> <p>Ensure that the current and non-current portions of the long-term debt presented on the balance sheet are based on the terms of the new contractual arrangements.</p>
<p>Obtain a <u>written</u> waiver from the creditor which:</p> <ul style="list-style-type: none"> • Covers a period greater than one year from the balance sheet date; • Waives all covenants; and • Specifies that the creditor has waived its right to demand payment for that period. 	<p>A copy of the written waiver.</p>	<p>Disclosure of the covenant violation and the waiver is desirable.</p>
<p>Obtain a <u>written</u> waiver from the creditor which:</p> <ul style="list-style-type: none"> • Covers a period greater than one year from the balance sheet date; • Waives only the covenants violated; • Specifies that the creditor has waived its right to demand payment for that period; <p>AND</p> <p>Ensure that it not likely that you will violate the unwaived covenants within one year of the balance sheet date.</p>	<p>A copy of the written waiver.</p> <p>Documentation supporting the fact that the unwaived covenants will likely not be violated within one year of the balance sheet date. Such documentation could include cash flow projections/budgets or contracts in place (if any) regarding new product lines, sales contracts, etc.</p>	<p>Disclosure of the covenant violation and the waiver is desirable.</p>
<p>Obtain a <u>written</u> waiver from the creditor which:</p> <ul style="list-style-type: none"> • Specifies that the creditor has waived or modified specific covenants covering the balance sheet date; <p>AND</p> <p>Depending on which of the original or modified covenants that will be in effect within one year of the balance sheet date, ensure that it is not likely that you will violate the original/modified covenants at that time.</p>	<p>A copy of the written waiver.</p> <p>Documentation supporting the fact that the original/modified covenants will likely not be violated within one year of the balance sheet date. Such documentation could include cash flow projections/budgets or contracts in place (if any) regarding new product lines, sales contracts, etc.</p>	<p>Disclosure of the covenant violation and the waiver is desirable.</p>

2. Covenant Violations are Likely in the Upcoming Year

Another situation may arise where you are **not** in violation of the debt covenants at the balance sheet date but may be in violation of the covenants in the upcoming year. (Note that this situation is different from the preceding one because your company was in compliance with its debt covenants at the balance sheet date).

For example, if you are close to your debt covenants at the balance sheet date and expect to experience declining income or to lose a major customer in the near future, it may be fair to assume that you will likely violate your debt covenants in the upcoming year. You would also be in this situation if, subsequent to the balance sheet date (but before the release of the financial statements), a violation has, in fact, occurred.

In these situations, you **can continue to classify the debt as long-term with the appropriate additional disclosures unless:**

- facts and circumstances other than the future covenant violation indicate that the debt should be reclassified as current. For example, if the entity has filed for bankruptcy, the debt should be reclassified as current as the assets and liabilities must be recorded on a liquidation basis.

<i>What Can You Do to Ensure that the Debt Remains Long-term on Your Balance Sheet?</i>	<i>What Documentation Should You Provide to Your Auditor/ Public Accountant?</i>	<i>What Disclosure is Required in Your Financial Statements?</i> <i>(See Appendix A for sample note disclosures).</i>
As long as facts and circumstances do not indicate otherwise, the debt can be classified as long-term.	Documentation to satisfy the auditor/ public accountant that no circumstances exist to cause reclassification.	Ensure that the financial statements have adequate note disclosure about the likely failure to satisfy the debt covenants in the future and the adverse effects of such failure. If actual violations occurred subsequent to the balance sheet date (but before the release of the financial statements), ensure that the financial statements include subsequent events disclosure describing the nature and adverse consequences of the covenant violation.

3. Demand Loans

Demand loans are those where the creditor has a unilateral right to demand immediate repayment of any portion or all of the debt under any provision of the debt agreement. These may include bank loans where the bank has a right to demand repayment at any time (even if the debt has scheduled repayment terms) or shareholder loans whose agreements contain a demand feature. You may **continue to classify this debt as long-term** as long as you comply with **one** of the following:

<i>What Can You Do to Ensure that the Debt Remains Long-term on Your Balance Sheet?</i>	<i>What Documentation Should You Provide to Your Auditor/ Public Accountant?</i>	<i>What Disclosure is Required in Your Financial Statements?</i> <i>(See Appendix A for sample note disclosures).</i>
Obtain a written waiver from the creditor which: <ul style="list-style-type: none"> • Covers a period greater than one year from the balance sheet date; • Covers covenant violations (if any); and • Specifies that the creditor has waived its right to demand payment for that period. 	A copy of the written waiver.	Disclosure of the demand feature and the waiver is desirable.

<i>What Can You Do to Ensure that the Debt Remains Long-term on Your Balance Sheet?</i>	<i>What Documentation Should You Provide to Your Auditor/ Public Accountant?</i>	<i>What Disclosure is Required in Your Financial Statements?</i>
<p>Examine the loan agreement to determine whether the creditor is able to demand repayment of the loan if certain subjective clauses are in default (i.e., there has been a “material adverse change” in the borrower’s operations, there is a “failure to maintain satisfactory operations” by the borrower, an “event of default” occurs (i.e., adverse changes that occur in the financial condition of the borrower), or “adequate” inventory levels are maintained).</p> <p>(Note, if the loan agreement also contains measurable covenants that are in default, please refer to Situation # 1, <i>Covenant Violations at the Balance Sheet Date</i>.)</p>	<p>Confirmation that these subjective clause(s) are not in default.</p> <p>If it is not clear that the subjective clause(s) are in default, provide confirmation that the creditor has not historically demanded repayments of loans containing similar clauses;</p> <p>AND</p> <p>Documentation regarding financial condition, i.e., cash flow projections/budgets, etc.</p>	<p>Disclosure of the subjective covenants and the likelihood of the creditor demanding repayment is desirable.</p>
<p>Refinance the debt on a long-term basis (please see Situation # 4, <i>Debt Matures This Year</i>, below).</p>		

4. Debt Matures This Year

If your debt is scheduled to mature within one year from the balance sheet date (or if it is a demand loan as described above), you may **continue to classify the debt as long-term** as long as you comply with **one** of the following:

<i>What Can You Do to Ensure that the Debt Remains Long-term on Your Balance Sheet?</i>	<i>What Documentation Should You Provide to Your Auditor/ Public Accountant?</i>	<i>What Disclosure is Required in Your Financial Statements?</i>
		<i>(See Appendix A for sample note disclosures).</i>
<p>Between the balance sheet date and the date the balance sheet is completed, enter into a long-term obligation or issue equity securities for the purpose of refinancing the short-term obligation on a long-term basis.</p>	<p>Documentation of the financing agreement or evidence of equity securities issuance.</p>	<p>Appropriate subsequent events disclosures.</p> <p>Current and long-term portion allocated in accordance with refinancing agreement.</p>
<p>Before the balance sheet is completed, enter into a financing agreement that clearly permits you to refinance the short-term obligation on a long-term basis, and ensure that all of the following conditions are met:</p> <p>i) The agreement does not expire and cannot be cancelled by the lender within one year;</p> <p>ii) No violation of any provision in the financing agreement exists at the balance sheet date or in the subsequent events period; and</p> <p>iii) The lender or investor with which you have entered into the financing agreement is expected to be financially capable of honoring the agreement.</p>	<p>Documentation of the financing agreement.</p>	<p>Appropriate subsequent events disclosures.</p> <p>Current and long-term portion allocated in accordance with refinancing agreement.</p>

Conclusion

Both EIC's could require significant changes in balance sheet presentation. If you fall into any of the scenarios presented, you will need to ensure that you follow the recommended guidance and obtain any necessary waivers from your creditors (i.e., banks, related parties, etc.). (Please see Appendix B for sample waivers).

You may find that, in some instances, banks/creditors are not willing to provide such waivers. In those situations, you may need to enter refinancing arrangements or be faced with no choice but to reclassify the debt as current.

Please note that if you would like to reclassify the debt as current, you will not need to follow the recommendations presented in this publication.

If you have any questions about the information presented in this publication, please feel free to discuss them with your local BDO Dunwoody partner.

Appendix A

Sample Note Disclosures

Please note that sample note disclosures have only been provided for some of the common situations that may arise. Note disclosure for all the different types of situations that could arise have not been provided.

Current Violation with Grace Period to Cure the Violation

The agreement with respect to the debenture payable contains certain covenants regarding ... The entity was not in compliance with the covenant related to ... on December 31, 2001. The debenture, however, contained a grace period to January 31st, 2002 in which to cure the violation. During this time, the entity entered into a refinancing arrangement with the bank that allowed for the modification of certain covenants so that they were no longer breached as at the balance sheet date.

Current Violation with Waiver of Specific Covenants Violated

The agreement with respect to the debenture payable contains certain covenants regarding ... The entity was not in compliance with the covenant related to ... on December 31, 2001. The creditor, however, waived its right to call the loan during the upcoming fiscal year with respect to the violation.

Current Violation with a Temporary Elimination, Modification or Waiver of the Covenants at Balance Sheet Date

The agreement with respect to the debenture payable contains certain covenants regarding The entity was not in compliance with the covenant related to ... on December 31, 2001. The creditor has provided the entity with a temporary waiver of this covenant at the balance sheet date.

No Current Violation (but Likely Violation in the Upcoming Year)

The agreement with respect to the debenture payable contains certain covenants regarding ... The entity was in compliance with the covenant related to ... on December 31, 2001. However, due to the loss of a major customer in January 2002, it is likely that the entity will no longer be able to maintain its 2:1 current ratio as specified in the debenture agreement. If the covenant is not met, the debenture may become due within the upcoming year.

Demand Loan with Waiver

The agreement with respect to the debenture payable contains a demand feature whereby the creditor can demand repayment at any time. The creditor, however, has waived its right to call the loan during the upcoming fiscal year.

Debt Maturing in Upcoming Year with Refinancing Agreement in Place

The debenture payable was expected to mature on February 28th, 2002. In January 2002, the entity entered into a refinancing agreement to extend this date to February 28th, 2003.

Appendix B
Sample Waivers

Sample Wording re: Waiver from Bank – Demand Loan

The following wording should be modified as appropriate depending on the type of waiver to be obtained (i.e., temporary waiver at balance sheet date, waiver of all covenants, waiver of subjective covenants, etc.).

[Bank Letterhead]

Private and Confidential

[Date]

[Client Name]

[Client Address]

[Client City]

[Client Postal Code]

Attention: [VP Finance / Controller]

Re: [Client Name]

XYZ Bank of Canada (the “Bank”) refers to the [Lending Agreement Title] (“the Agreement”) dated [Agreement Date] between [Client Name] (the “Borrower”) and XYZ Bank of Canada.

Upon examination of the financial information supplied to the Bank by the Borrower, it has been determined that the Borrower was in non-compliance with Covenants [reference to Agreement paragraphs where violated] as at [Year/Period End].

While the Bank does not waive its rights in respect of such breaches, it will not demand payment of any of the Agreement loans as a result of the breaches at [Year/Period End] for a period of at least 12 months from [Year/Period End]. This does not preclude, revoke or impair the Bank’s right to demand repayment of the loans for all subsequent covenant violations pursuant to the Agreement.

Yours truly,

[Bank Representative]

[Bank Rep Title]

cc. [Partner]

BDO Dunwoody LLP

Appendix B (cont.)
Sample Waivers

Sample Wording re: Waiver from Related Party

I hereby confirm that the amount of \$- due to me by the above mentioned party as at November 30, 200X is correct.

Security for the loan is ...

Payment is due ... Interest rate is -% per annum.

I will waive the right to demand payment during the fiscal year ending November 30, 200Y.