MFRS 101 Amendments:
Implications for Liability Classification in Covenant Agreements

June 2024

Audit / Tax / Advisory

Smart decisions. Lasting value.

What is the loan's classification?

A long-term loan did not meet the debt/equity ratio covenant on 31 December. But the covenant compliance result will only be reported to the lender 2 months later based on audited figures.

Short-term loan?

NO!
Long-term loan!

Introduction

Generally, a (portion of) loan is presented as a non-current liability if it is not due for repayment within the next 12 months. This classification principle is governed by MFRS 101 'Presentation of Financial Statements'.

However, there are grey areas in classifying a loan as a current or non-current liability typically arising from the interpretation of accounting standards and the specific circumstances surrounding a default. Based on the dialogue above, someone may argue that the defaulted loan is:-

- **Current liability:**
  The borrower has breached a provision of the long-term loan, and the loan becomes repayable on demand.

- **Non-current liability:**
  The lender has not demanded immediate repayment of the loan. Moreover, the outcome of the breach could only be known 2 months later after the lender has reviewed the compliance result.

With limited guidance in MFRS 101, the classification requirement has led to diverse practices and challenges for the classification of liabilities. In December 2022, the Malaysian Accounting Standards Board (MASB) issued amendments to MFRS 101 *'Non-current Liabilities with Covenants*' (the Amendments) to resolve these issues.

A loan covenant is a condition imposed by a lender that must be adhered to by the parties involved to protect the lender's interest by ensuring that the borrower maintains specific financial ratios, operational performance levels or other conditions throughout the loan tenure. These covenants always cover metrics such as debt-to-equity ratio, liquidity, profitability and may impose limits on capital expenditures and dividend distributions.

© 2024 Crowe Malaysia PLT

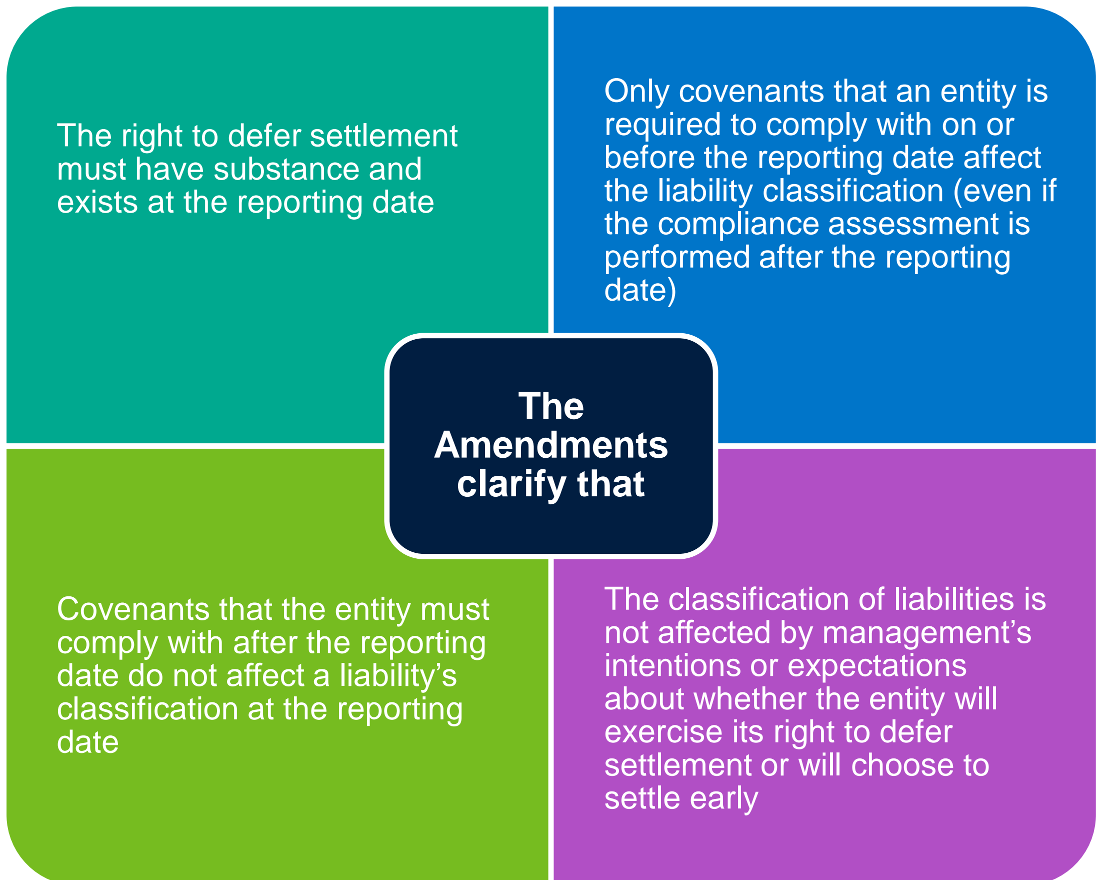
About the Amendments

Existing MFRS 101 requires a liability to be classified as current typically when an entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period. But in the real world, the right to defer settlement of liability is rarely unconditional because most loan arrangements contain conditions or covenants that the borrower must meet in order to continue deferring settlement beyond 12 months from the reporting date.

The Amendments have deleted the word ‘unconditional’ from the classification principle in MFRS 101. As a result, a liability is classified as non-current if an entity has the right to defer settlement of the liability for at least 12 months from the reporting date. This update may particularly impact convertible loans, roll-over facilities and other debts with covenants.

This article focuses on the classification of loans with covenants as current or non-current. It does not address the classification of other types of liabilities.

Right to Defer Settlement of Liability



To illustrate the new requirements of the Amendments, let's consider the 3 examples below:-

© 2024 Crowe Malaysia PLT

Example 1 – Covenant is Met at the Reporting Date

Background

Entity A obtains a loan from Bank B on 1 January 20X1 of which the loan is repayable in full after 5 years. Considering the seasonal nature of Entity A's business, the loan arrangement requires Entity A to have a working capital ratio of more than 1.5 as at every 30 September. Otherwise, Bank B has the right to demand immediate repayment of the loan.

Entity A is having a financial year-end of 31 December.

Covenant Positions

30 September 20X1 (compliance assessment date): Working capital ratio of 1.6

31 December 20X1 (reporting date): Working capital ratio of 1.3

Analysis

Entity A meets the covenant requirement on 30 September 20X1. Therefore, the loan is classified as "non-current" as at 31 December 20X1 because the right to defer settlement of the loan for a period exceeding 12 months exists on that date (even though the working capital ratio on that date is less than 1.5 but it is not the covenant requirement).

© 2024 Crowe Malaysia PLT

Example 2 – Covenant is not Met at the Reporting Date

Background

Same facts per Example 1.

Covenant Positions

30 September 20X1 (compliance assessment date): Working capital ratio of 1.2

31 December 20X1 (reporting date): Working capital ratio of 1.7

Analysis

A breach of covenant occurred on 30 September 20X1, resulting in Bank B having the right to demand immediate repayment of the loan. As at 31 December 20X1, the loan remains classified as "current" due to the previous breach on 30 September 20X1 because Entity A does not have the right to defer settlement on the reporting date.

Breach is waived during the current reporting period with additional future covenant

If Bank B provides a waiver for the covenant violation on or before 31 December 20X1 and inserts an additional covenant test based on Entity A's financial position as at 28 February 20X2, the loan will be reclassified to "non-current", assuming no breach existed as at 31 December 20X1.

Please take note that a future covenant does not affect a liability's classification at the reporting date but the Amendments require entities to disclose additional covenant information that enables users of financial statements to understand the risk that the liability could become repayable within 12 months after the reporting period.

Breach is waived after the reporting date

If the waiver of the breach is received after the reporting date, the waiver is a non-adjusting event. The loan will continue to be classified as "current" as at 31 December 20X1.

© 2024 Crowe Malaysia PLT

Example 3 – Period of Grace for Covenant Violation

Background

The same facts per Example 2 but Bank B has provided a period of grace for the covenant violation during the current reporting period.

Under the new arrangement, Bank B introduces a new covenant test based on Entity's A financial position as at 30 April 20X2 and will reconsider the loan settlement status based on the new working capital ratio covenant. Irrespective of the outcome of the covenant test in April 20X2, Bank B reserves its right to demand repayment of the loan with respect to the 31 December 20X1 covenant violation.

Covenant Positions

30 September 20X1 (compliance assessment date): Working capital ratio of 1.2

30 April 20X2 (future covenant compliance): Not relevant

Analysis

Bank B has retained its right to demand immediate repayment of the loan as at 31 December 20X1. The right arises from the original breach of covenant that occurred on 30 September 20X1 and not from a breach of the additional covenant.

Therefore, the loan is classified as "current" as at 31 December 20X1 because Entity A does not have the right to defer settlement on that date.

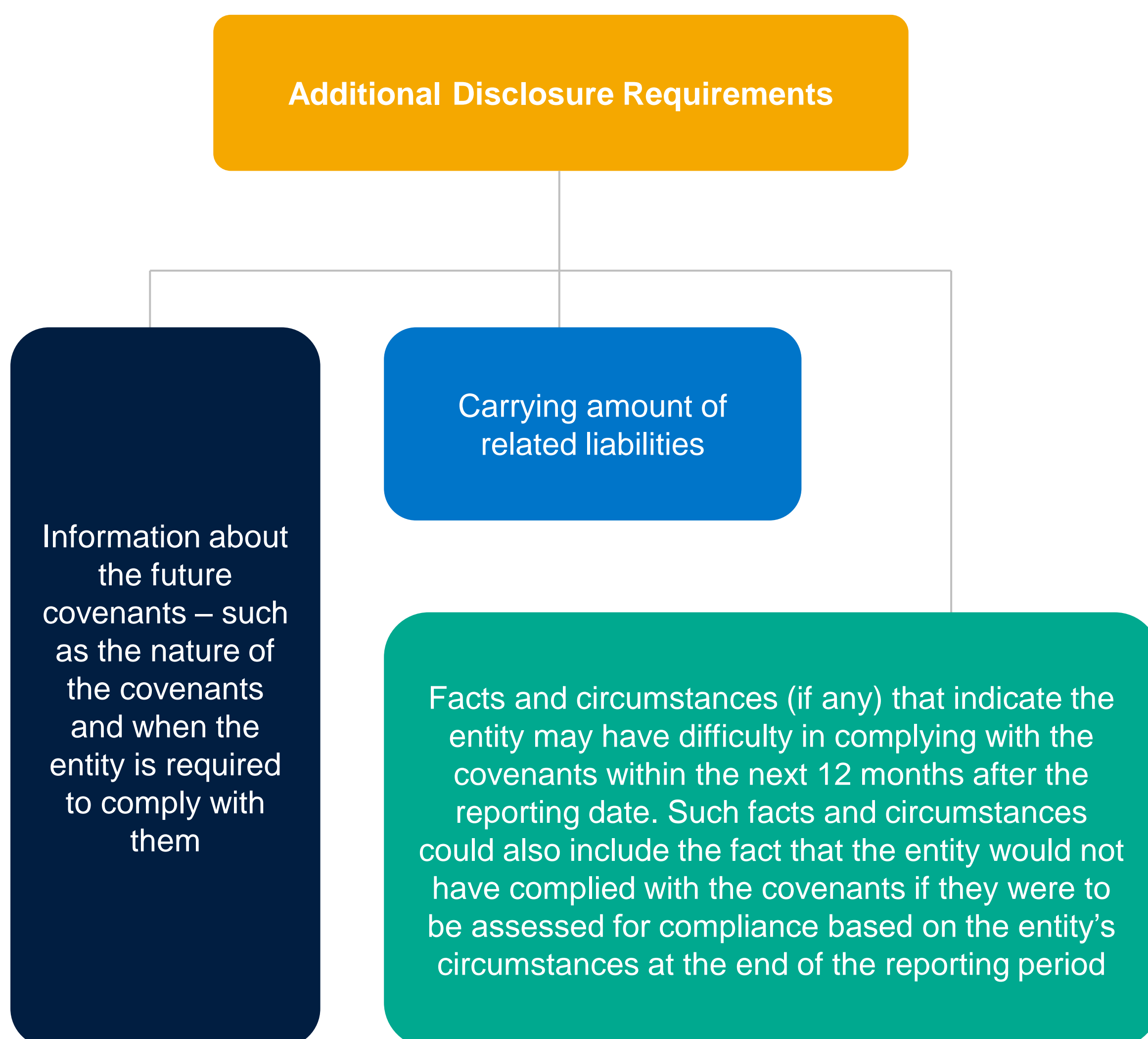
Some loan agreements may include covenants that are not based on financial ratios. When a loan agreement contains such subjective covenant clauses, for example, when the borrower experiences 'significant financial difficulties' clause, entities shall exercise judgement in determining whether that subjective covenant clause is breached.

© 2024 Crowe Malaysia PLT

Disclosure Requirements

The Amendments introduce additional disclosure requirements for situations in which an entity classifies liabilities from loan arrangements as non-current and its right to defer settlement of those liabilities is subject to meeting one or more covenants within 12 months from the reporting date (see Example 2).

In this case, the entity is required to disclose sufficient information to assist users of financial statements in understanding the risk that the liabilities could become repayable within 12 months after the reporting date.



© 2024 Crowe Malaysia PLT

Example 4 – Non-Current Liability that is Subject to Future Covenant

Background

Same facts per Example 1.

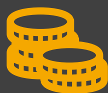
Covenant Positions

30 September 20X1 (compliance assessment date): Working capital ratio of 1.6

31 December 20X1 (reporting date): Working capital ratio of 1.3

Disclosures

The loan from Bank B of $XXX (20X0 - NIL) is repayable on 31 December 20X5. The loan arrangement requires Entity A to maintain a working capital ratio above 1.5 on 30 September every year; otherwise, the loan will be repayable on demand.



The covenant requirement on 30 September 20X1 was complied with and therefore, the loan is classified as non-current as at 31 December 20X1.

Based on a hypothetical test on 31 December 20X1, the working capital ratio would be 1.3 which does not meet the covenant requirement. In addition, Entity A expects its working capital ratio to further decline due to the recent economic downturn. Consequently, Entity A has approached Bank B for a waiver of a potential breach of covenant and to modify the existing covenant clauses. The negotiations are at the preliminary stage. If Entity A does not satisfy the upcoming covenant assessment on 30 September 20X2 and the potential breach of covenant is not waived by Bank B, the loan will become repayable on demand.

© 2024 Crowe Malaysia PLT

Conclusion

The Amendments are effective for annual reporting periods beginning on or after 1 January 2024.

Entities shall thoroughly reassess their liabilities, particularly those with covenants because the Amendments could greatly affect how the liabilities are presented in the statement of financial position. This, in turn, could affect the entity's financial metrics such as gearing and current ratios.

Along with the reassessment of the liabilities, entities may need to renegotiate covenant clauses with lenders in a timely manner to prevent potential breaches that could impact the classification of the liabilities.

This article was written by:

James Chan
Partner,
Audit & Assurance
james.chan@crowe.my

© 2024 Crowe Malaysia PLT

Contact us

Crowe Malaysia PLT
Level 15, Tower C
Megan Avenue II
12, Jalan Yap Kwan Seng
50450 Kuala Lumpur
Malaysia

Tel. +603 2788 9898

About us

About Crowe Malaysia
Crowe Malaysia is the 5th largest accounting firm in Malaysia and an independent member of Crowe Global. The firm in Malaysia has more than 10 offices, employs over 1,200 staff, serves mid-to-large companies that are privately-owned, publicly-listed and multinational entities, and is registered with the Audit Oversight Board in Malaysia and the Public Company Accounting Oversight Board in the US.

About Crowe Global
Crowe Global is one of the top 10 accounting networks with over 200 independent accounting and advisory firms in more than 145 countries. For almost 100 years, Crowe has made smart decisions for multinational clients working across borders. Our leaders work with governments, regulatory bodies and industry groups to shape the future of the profession worldwide. Their exceptional knowledge of business, local laws and customs provide lasting value to clients undertaking international projects.

www.crowe.my

Crowe Malaysia PLT is a member of Crowe Global, a Swiss verein. Each member firm of Crowe Global is a separate and independent legal entity. Crowe Malaysia and its affiliates are not responsible or liable for any acts or omissions of Crowe or any other member of Crowe Global and specifically disclaim any and all responsibility or liability for acts or omissions of Crowe Global or any other Crowe member.
© 2024 Crowe Malaysia PLT