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2018

BANK COVENANTS – THEMATIC REVIEW

OCTOBER 2018

IRISH AUDITING AND ACCOUNTING SUPERVISORY AUTHORITY

MISSION

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest

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1. INTRODUCTION

1.1 Background

IAASA, Ireland's accounting enforcer, has responsibility for the examination and enforcement of certain listed entities' ('issuers') periodic financial reports.

IAASA has performed a desk-top review of the bank covenant disclosures that issuers included in their 2017/18 financial reports. The disclosure of financial ratios and terms agreed with the lenders, together with the basis of calculation of those ratios is relevant information for the users of financial reports. The disclosure of such information assists users of financial reports in assessing the creditworthiness and liquidity risk of an entity. Such information is particularly relevant for users of financial reports of entities which are in a vulnerable financial position.

Section 3 of this Paper presents the results of this desk-top review.

Section 4 sets out the IAASA examination activity relating to issuers' bank covenant disclosures following our annual examination programme.

IAASA's review is based on the 2017/18 annual financial reports published by 27 equity issuers falling within IAASA's financial reporting review remit (see Appendix). The following issuers were not included in our desk-top review because these issuers are banks:

(a) AIB Group plc;

(b) Bank of Ireland Group plc;

(c) Permanent TSB Group Holdings plc; and

(d) Bank of Cyprus Holdings plc.

Readers should note that, in undertaking this review, additional information was not sought from the selected issuers.

1.2 Relevant IFRS provisions

Paragraphs 134 and 135 of IAS 1 *Presentation of Financial Statements* requires entities to provide a description of what they manage as capital and to disclose the nature of any externally imposed capital requirements. Some entities regard bank loans as capital and include relevant bank loan information within their capital management disclosures. Depending on the individual circumstances of the issuer, if bank loans are included as capital and such bank loans include financial covenants that must be achieved, then such information would need to be disclosed under IAS 1.134 and IAS 1.135.

Paragraph 18 of IFRS 7 *Financial Instruments: Disclosures* requires the following information to be disclosed when a breach of bank covenant occurs:

> '*For* loans payable *recognised at the end of the reporting period, an entity shall disclose:*
>
> *(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;*
>
> *(b) the carrying amount of the loans payable in default at the end of the reporting period; and*
>
> *(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.'*[1]

In addition, IFRS 7.IG12 is relevant to this matter and states:

[1] Readers' attention is drawn to paragraphs 4 to 6 of IAS 10 *Events After the Reporting Period* for further guidance

> *‘Paragraphs 18 and 19 require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IAS 1 …’*

2. PURPOSES OF THE REVIEW

The primary purposes of this review are to:

(a) determine the range of bank covenants with which issuers must comply;

(b) determine the nature and extent of bank covenant information disclosed by issuers; and

(c) provide preparers, auditors and users of financial statements with information to encourage discussion and stimulate debate on disclosures regarding bank covenants.

3. BANK COVENANT REVIEW RESULTS

3.1 Total debt recognised and common covenants used by issuers

IAASA’s desk-top review identified that 22 issuers[2] had combined total debt amounting to €25.5bn (2016/17: €25.9bn) recognised in their most recent financial reports. It was noted that the lowest level of debt recognised by one issuer was €10m, while another issuer recognised the highest level of debt amounting to €7.9bn. The total cash recognised by the 22 issuers amounted to €9.95bn (2016/17: €11.5bn).

The review identified a number of different types of covenants that lenders/debt providers impose on issuers. The following covenants were identified from the review:

(a) net debt to EBITDA (‘Earnings before interest, tax, depreciation and amortisation’);

(b) EBITDA to net interest;

(c) adjusted EBIT (‘Earnings before interest and tax’) to net finance cost;

(d) minimum net worth – defined as total equity plus deferred tax liabilities and capital grants less repayable capital grants;

(e) group gearing;

(f) minimum cash balance;

(g) net debt to equity; and

(h) minimum shareholders’ equity.

In addition, the review also identified that the 22 issuers have a combined amount of €9.6bn of undrawn loan commitments available to them at their most recent reporting date.

3.2 Bank covenants – non-disclosure of covenants, basis of calculation and actual results

IAASA’s review identified that of the 22 issuers which have debt recognised on their balance sheets:

(a) 8 issuers did not disclose a description of their covenants imposed by their lenders/debt providers. However, 3 of these 8 issuers stated that they had complied with their debt covenants. While 1 of the 8 issuers did not make any reference to covenants in its annual report;

(b) 2 issuers disclosed the terms of their covenants but did not disclose the actual measures achieved;

[2] The remaining 5 issuers included in this desk-top review (Aminex plc, Datalex plc, FBD Holdings plc, IFG Group plc and Independent News and Media plc) did not have any bank borrowings recognised in their balance sheets

(c) 2 issuers disclosed the terms of one of their covenants, together with actual measures achieved. However, these 2 issuers did not provide any information (e.g. the terms or the actual measures achieved) of the other covenants imposed; and

(d) 2 issuers disclosed both the covenant terms and the actual measures achieved. However, the reconciliation/basis of calculation of the actual measures achieved was not readily apparent from the disclosures in the financial statements. In two instances, the reconciliation/basis of calculation of the net debt to EBITDA ratio per the covenant agreement was not disclosed in the financial statements and the ratio could not be calculated using the adjusted IFRS amounts.

4. IAASA ACTIVITY RELATING TO ISSUERS' BANK COVENANT DISCLOSURES

As part of its programme of examining the financial statements of issuers, IAASA has engaged with a number of issuers regarding their bank covenant disclosures.

The table below summarises the outcome of such engagement with some issuers.

TABLE – IAASA ACTIVITY RELATING TO ISSUERS' BANK COVENANT DISCLOSURES

	Matter raised	Outcome
1.	Directors' confirmation as to whether or not the issuer had breached its covenants and whether the information required by IFRS 7.18 and IFRS 7.19 had been disclosed in the financial statements.	The directors provided undertakings to include the information required by IFRS 7.18 and IFRS 7.19 in future periodic financial reports.
2.	Directors' explanation as to why the calculation of the net debt to EBITDA ratio for financing purposes differs from the net debt to EBITDA ratio calculated using the adjusted IFRS numbers.	The directors provided an undertaking to include the basis of calculation of the net debt to EBITDA ratio for financing purposes in future periodic financial reports.

5. CONCLUSIONS

IAASA will continue to focus on and, depending on the specific circumstances, engage with issuers in relation to:

(a) the directors' rationale for not disclosing a description of the covenants imposed by the issuer's lender/debt provider;

(b) the reconciliation/basis of calculation of the covenants per the lending agreement;

(c) the disclosure of the penalties for breaching a bank covenant; and

(d) the disclosure of the information required by IFRS 7.18 and IFRS 7.19 when a breach of a covenant has occurred.

APPENDIX

ISSUERS INCLUDED IN THIS REVIEW

	Issuer	Report
1	Aminex plc	31 December 2017
2	Aryzta AG	31 July 2017
3	C&C Group plc	28 February 2018
4	Cairn Homes plc	31 December 2017
5	CRH plc	31 December 2017
6	Dalata Hotel Group plc	31 December 2017
7	Datalex plc	31 December 2017
8	DCC plc	31 March 2018
9	FBD Holdings plc	31 December 2017
10	Glanbia plc	31 December 2017
11	Glenveagh Properties plc	31 December 2017
12	Grafton Group plc	31 December 2017
13	Green REIT plc	30 June 2017
14	Greencore Group plc	30 September 2017
15	Hibernia REIT plc	31 March 2018
16	IFG Group plc	31 December 2017
17	Independent News & Media plc	31 December 2017
18	Irish Continental Group plc	31 December 2017
19	Irish Residential Properties REIT plc	31 December 2017
20	Kenmare Resources plc	31 December 2017
21	Kerry Group plc	31 December 2017
22	Kingspan Group plc	31 December 2017
23	Mainstay Medical International plc	31 December 2017
24	Paddy Power Betfair plc	31 December 2017
25	Ryanair Holdings plc	31 March 2018
26	Smurfit Kappa Group plc	31 December 2017
27	UDG Healthcare plc	30 September 2017