Accounting for Debt Financing and Going-Concern Issues

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Introduction

In the past, not-for-profit organizations have generally been able to manage their affairs in a way that avoided being heavily dependent on debt financing. Times have changed. Government funding has not been keeping pace with inflation. New programs are being developed to meet the needs of the community. Facilities are aging and need to be updated to meet new program needs and higher standards in building codes. Fundraising to pay for these items is expensive and challenging because of donor fatigue. These and other pressures are resulting in organizations having to increase debt levels to be able to continue to fund their operations and projects.

Required Disclosures About Debt

There are a number of disclosures in the financial statements for debt required by *The Canadian Institute of Chartered Accountants' Handbook* (*CICA Handbook*) (Section 3210) that are generally provided in the notes to the financial statements. These include:

- The title of the issue, the interest rate, maturity date, amount outstanding and the existence of a sinking fund, and redemption and conversion provisions;
- The aggregate amount of payments estimated to be required in each of the next five years to meet sinking fund or retirement provisions;
- Where debt is payable in a currency other than that in which the balance sheet is stated, the currency in which the debt is payable must be noted;
- Any of the liabilities that are secured should be stated separately and the fact that they are secured should be indicated; and
- Interest on indebtedness initially incurred for a term of more than one year.

There are a number of specific requirements related to obligations associated with capital leases. Where a lease effectively represents the purchase of an asset that is being financed by debt, the *CICA Handbook* (Section 3065) requires that both the asset and liability be presented separately in the financial statements. As well, disclosure is required of:

- Future minimum lease payments in aggregate and for each of the five succeeding years, with a separate deduction for executory costs and imputed interest;
- Interest rates and expiry dates; and
- Significant restrictions imposed on the lease as a result of the lease agreement.

Classification of Debt on the Balance Sheet

In preparing financial statements, management must consider the proper presentation of debt. The *CICA Handbook* provides a number of guidelines related to the classification of debt on the balance sheet. Any debt where the lender has the unilateral right to demand immediate repayment within one year from the date of the balance sheet must generally be classified as a current liability. Sometimes the debt may have repayment terms beyond one year but includes a provision that enables the lender, at its discretion, to demand payment at any time. For example, the debt agreement could contain words such as: "the term note shall mature in monthly instalments as set forth therein or on demand, whichever is earlier". This type of debt should also be classified as current. ("CICA Emerging Issues Committee Abstract (EIC) – 122")

If there are repayment terms that provide for the payment of the debt beyond one year from the balance sheet date and the lender has no unilateral right to demand payment, the portion of the debt that is repayable beyond one year would normally be classified as long-term. (The classification where long-term debt becomes repayable within one year because of violations of debt covenants is discussed in a later section.)

Sometimes an organization borrows funds pursuant to a long-term credit facility however, the actual borrowings are evidenced by short-term obligations such as bankers' acceptances which are "rolled over". In this situation, the organization must have a committed facility that gives it the contractual right, exercisable at its sole discretion, to roll over the short-term obligations for a period of more than one year in order for all or part of this debt to be classified as long-term. The lender cannot have the right to unilaterally cancel the facility. (*CICA Handbook* EIC-122)

Sometimes when an obligation is repayable within a year, there is a contractual arrangement to settle the debt from other than current assets. In this situation, the debt should be classified as long-term. An example of this situation would be a maturing bond issue where contractual arrangements have been made for long-term refinancing. (*CICA Handbook* 1510.06)

In other situations, debt is scheduled to mature within one year from the balance sheet date or is otherwise callable by the lender however, the organization intends to renegotiate or refinance the obligation on a long-term basis. The

CICA Handbook (EIC-122) provides that this debt can only be excluded from current liabilities if this intent is supported by an ability to successfully complete the refinancing. This ability can be demonstrated in either of the following ways:

(a) After the balance sheet date, but before the financial statements are issued, debt with payment terms beyond one year is issued for the purpose of refinancing the short-term obligation.

(b) Before the financial statements are completed, the organization enters into a financing agreement that clearly permits the debtor to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:

The agreement does not expire within one year from the date of the organization's balance sheet and during that period the agreement is not cancelable by the lender and repayment of the debt cannot be demanded except for violation of a provision with which compliance is objectively determinable or measurable;

No violation of any provision in the financing agreement exists at the balance sheet date and no available information indicates that a violation has occurred thereafter but prior to the completion of the balance sheet or, if one exists at the balance sheet date or has occurred thereafter, a waiver has been obtained;

The lender with which the organization has entered into the financing agreement is expected to be financially capable of honouring the agreement.

Covenants in Debt Agreements

The debt agreement signed by an organization will include a number of requirements that must be met by the organization. These can be quite straightforward, such as providing a set of audited financial statements, or be more demanding, such as the maintenance of limits on certain activities or expenditure levels of the organization. As well, agreements for debt that mature beyond one year normally include a number of financial tests which must be met. These tests typically include maintenance of specified financial ratios over a period of time or at a specific point in time. These covenants can sometimes be quite onerous and it is not uncommon for an organization to violate one or more of them.

When there is a covenant violation at the balance sheet date that gives the lender the right to demand payment of the debt within one year of the date of the balance sheet, the *CICA Handbook* (EIC-59) requires that the debt be reclassified as a current liability unless the following conditions are met:

(i) the creditor has waived in writing, or subsequently lost, the right, arising from violation of the covenant at the balance sheet date, to

demand repayment for a period of more than one year from the balance sheet date; or the debt agreement contains a grace period during which the debtor may cure the violation, and contractual arrangements, with significant economic consequences to the parties if breached, and which the parties have little, if any, discretion to avoid, have been made which ensure that the violation will be cured within the grace period; and

(ii) A violation of the debt covenant giving the creditor the right to demand repayment at a future compliance date within one year of the balance sheet date is not likely.

Classification of long-term debt as current often results in a working capital deficiency which may demonstrate an inability to pay liabilities as they come due. This situation is discussed below in the section addressing going-concern considerations.

The *CICA Handbook* (EIC-59) provides further clarification on several issues. It indicates that:

> If the creditor is callable because of violations of certain provisions of the debt agreement, the creditor needs to waive its right only with regard to those specific violations.

It also states that:

> The creditor's waiver or loss of its right to demand repayment for a period of more than one year from the balance sheet date refers only to the lender's right arising from the covenant violation which occurred at the balance sheet date. It does not refer to creditor's rights with respect to any new covenant violation that may arise at a future compliance date.

Examples are given of circumstances where the creditor would lose the right to demand repayment. These include situations where the debtor has cured the violation after the balance sheet date and the debt is not callable at the time the financial statements are issued or the debt has been refinanced on a long-term basis.

The *CICA Handbook* (Section 3210.08) requires that the details of any defaults with respect to an outstanding obligation, which generally include covenant violations, should be disclosed in the financial statements. Even when the debt agreement contains a grace period and contractual arrangements have been made which ensure that the violation will be cured within the grace period, an organization continuing to disclose the debt as long-term must disclose the circumstances of its violation and the substance of the contractual arrangements. (*CICA Handbook* EIC-59)

The *CICA Handbook* (EIC-59) highlights that fact that the violation of a covenant on one debt obligation may result in violations on other debt obligations. An organization needs to take account of all cross-violation clauses and the reclassification of other debt, in determining whether covenants applicable to a particular debt obligation have been violated.

The *CICA Handbook* (EIC-59) addresses the situation where an organization is in compliance with debt covenants at year end (without the need for the temporary elimination, modification or waiver of covenants) but it appears likely that it may violate one or more covenants during the next fiscal year that will give the lender the right to demand repayment. In this situation, the *Handbook* indicates that "unless facts and circumstances indicate otherwise, long-term debt should not be re-classified as a current liability" however, disclosure of the likely breach of covenants in the future and the consequences of the failure should be disclosed. Further, if the covenant violation occurs after the end of the fiscal year but before the date of completion of the financial statements, a subsequent-events note should be included describing the nature and adverse consequences of the violation.

Going-Concern Considerations

Because not-for-profit organizations are now more likely to have debt obligations, they are more dependent on the support of third parties for their survival. Lenders have to be willing to continue to extend lines of credit to an organization for it to be able to continue operating. In the last few years, it has been more common for not-for-profit organizations to breach loan covenants and/or not be able to operate within the lines of credit available to them. When this situation arises, whether or not the organization is a going concern has to be assessed and the financial statements may require additional disclosures and possibly reclassifications of assets and liabilities.

Financial statements are prepared under the presumption that an organization is going to continue operating for the foreseeable future. As a result, the expectation is that the assets and liabilities of the organization will be realized and discharged, respectively, in the normal course of operations. If an organization is not expected to continue operating, the normal approach to valuing assets and liabilities may no longer be appropriate. Therefore, in preparing a set of financial statements, management must consider the ability of the organization to continue as a going concern. Auditors reconsider this presumption on an annual basis and extend their enquiries when the presumption appears doubtful.

There are a number of warning signs that point to the potential inability of an organization to continue as a going concern. These include:

- A failure to comply with the terms of borrowing agreements

- Violations of covenants contained in debt agreements
- The inability to pay liabilities when they come due
- Significant outstanding legal claims
- Recurring operating losses
- Current liabilities in excess of current assets
- Negative net assets
- Significant reductions in funding from key funders
- Uneconomical long-term commitments
- Fundraising campaigns not meeting the target required to fund a project already initiated.

When one or more of these signs is present, auditors must extend their procedures to satisfy themselves that the going-concern assumption is appropriate. Ultimately, the auditor has to be satisfied that the organization has financial and other resources available to allow it to continue operating for at least one year from the date of the balance sheet on which an opinion is being given. Therefore, if an organization has a March 31st year-end, there must be evidence that the organization can continue operating until April 1st of the next year. Often, one of the most significant considerations is whether there is a committed line of credit sufficient to meet the projected cash flow requirements of the organization.

To make an assessment of whether an organization is able to continue operating, the auditor will require a cash flow statement that provides sufficient detail to judge whether available operating cash plus any lines of credit are sufficient to pay liabilities as they come due. At a minimum, this cash flow statement needs to provide monthly numbers for each of the major sources of funds and types of expenditures. Where the timing of cash flows is uncertain, the assumptions used to prepare the statement need to be set out. Where there is uncertainty about the assumptions, more than one version should be prepared in order to understand the impact of different outcomes. The preparation of the cash flow statement will need to consider an assessment of the impact of management's plans for dealing with the conditions or events that raise doubts about the organization's ability to continue operating. These plans might include reducing or deferring expenditures through measures such as laying off staff, not filling vacant positions, or consolidating office space.

A number of years ago, auditors were required to include a qualification to the auditors' opinion when there was significant uncertainty about an organization's ability to continue operating as a going concern. Reference to a going-concern issue is no longer required in the auditors' report.

Instead, references to any going-concern issues need to be made in the notes to the financial statements. Management and the auditors need to consider what, if any, disclosure is required about the future viability of an organization in order to provide fair presentation in the statements. The note needs to explicitly draw the reader's attention to the possibility that the organization may not be able to realize its assets and meet its current and future obligations in the ordinary course of business. Specifically, the note will contain reference to:

- the conditions or events that have given rise to the going-concern uncertainty; and
- the implications of these conditions or events.

A sample note is as follows:

> *Basis of Presentation*
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> These financial statements have been prepared on the going-concern basis which presumes that the organization will be able to realize its assets and discharge its liabilities in the normal course of operations for the foreseeable future.
>
> The organization has a working capital deficiency of $? [2001 -$?] after taking into account short and long-term bank indebtedness totalling $? [2001 - $?], an accumulated deficit of $? [2001 - $?] and deficiency of revenue over expenses for the year of $? [2001 - $?]. The organization is also in breach of debt covenants in relation to its bank loan *[note ?]*. The lender has not waived these violations and, while the lender has not indicated an intention to call its loan, this debt has been classified as a current liability in the accompanying balance sheet because the lender may now demand repayment.
>
> The organization's ability to continue as a going concern is uncertain and is dependent upon receiving additional contributions and upon either the continued support of the lender or upon the ability of the organization to raise alternative financing to replace this loan. The outcome of these matters cannot be determined at this time. These financial statements do not include any adjustments to the amounts and classification of assets and liabilities that might be necessary should the organization be unable to continue in business.

Careful consideration is required about when to disclose going-concern issues. It is difficult to forecast the future and it is important that the public not be given the impression that auditors are able to evaluate economic viability. Also, erroneous or premature going-concern disclosures could have unfortunate consequences for an organization. Normally, going-concern disclosures are made in situations where specific events have taken place which indicate that an organization may not be able to continue however, significant going-concern uncertainties may also exist in the absence of such specific events. These uncertainties may be the result of a combination of circumstances and prospects – including sustained heavy losses and urgent capital requirements in the near

future to meet debt obligations, with no definite prospects for obtaining needed capital or for a return to financial stability. It is important that each situation be evaluated in light of its particular circumstances.

A common situation for an organization that is having some financial difficulties is for the lender to reassess the line of credit on an annual basis and to want to make this assessment after receipt of the audited financial statements. The organization is placed in a difficult situation since without a new committed line of credit for the next year, the auditors may have to insist on the financial statements including the going-concern disclosure described above. Normally it is possible to convince the lender to use draft financial statements to make the final decision about renewing the line of credit in order to avoid this disclosure appearing in the issued financial statement.

In some situations, the ability of an organization to continue is unlikely. If at the time that the financial statements are to be issued it appears probable that the organization will have to discontinue operations, auditors will have to consider whether it is appropriate to issue an unqualified opinion, even with the going-concern disclosures. It may be necessary to either express an adverse opinion or deny an opinion.

Conclusion

When an organization enters into a debt agreement, there are a number of implications for the preparation of its financial statements that must be considered. As well, a number of situations may arise requiring careful consideration of the facts to ensure that the debt is properly reflected in the financial statements. As organizations find themselves in a position to require debt financing, they become more dependent on third parties for their ongoing survival. As a result, it is more likely that there may be some uncertainty about the ability of the organization to continue as a going-concern. In this situation, there are a number of matters that must be considered to ensure that the financial statements are fairly presented.