BANKING AND FINANCE

COVID-19 Practical Considerations: Impacts for borrowers on financial reporting and covenants

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Public health measures taken in response to the COVID-19 pandemic may affect borrowers' ability to comply with their financial reporting obligations in facilities agreements, while the economic impact of the pandemic should be reviewed in the context of compliance with financial and other covenants.

AUDITS

Audit Process Delays

In general, facilities agreements require that borrowers deliver annual audited financial statements within a set-time frame after their year-end (usually 90-180 days). Audit firms are, however, encountering significant difficulties in completing audit processes at the moment in light of both social distancing requirements, and restrictions on travel. In particular, this is likely to impact businesses where stock is material to the financial statements such that auditors are required to obtain appropriate evidence of the existence of that stock.

Concerns may also arise where remote working arrangements cause issues in terms of maintaining the adequacy of the borrower's usual internal controls (or the ability of auditors to verify such internal controls).

The delays in completing audit processes are likely to be a particular issue for companies with a 31 March year-end. Companies with a 31 December year-end are more likely to have completed at least part of their audit process before the closures and other public health measures taken in response to the COVID-19 pandemic.

It may be necessary to seek lender consent to extend the due date for the delivery of annual audited financial statements if the issue cannot instead be addressed by extending the accounting reference period beyond the originally scheduled year-end. Such an extension would, however, need to be permitted by the facilities agreement, and the requirements of the Companies Act 2014 would also need to be satisfied (i.e. that the relevant accounting period does not exceed 18 months and that there has been no extension to the company's annual return date within the previous five years).

Going concern

As part of the audit process, a borrower's management team is required to assess the ability of the business to continue as a going concern for at least twelve months from the date of approval of the relevant financial statements. This may present a particular issue for businesses that have been materially impacted by the closures and other public health measures taken in response to the COVID-19 pandemic, in particular where those businesses will have significant refinancing requirements during that twelve-month period, or require updated valuations within that period.

Audit qualifications/events of default

Many facilities agreements include, as an event of default, the annual audited financial statements being qualified by the borrower's auditors. This may be particularly relevant where there is a disagreement between the relevant borrower and its auditors as to whether those financial statements can be prepared on a '*going concern*' basis.

It should be borne in mind that the manner in which that event of default is drafted can vary considerably between facilities agreements. By way of example, it may be limited to qualifications resulting from a failure to provide or disclose information to the auditors, or it may exclude '*emphasis of matter*' statements or other modifications included in auditors' reports.

Adjusting events

Auditors are required to obtain sufficient evidence in relation to '*adjusting events*' occurring between the balance sheet date and the date of the auditors' report (including, where material, information on the nature of the event and an estimate of its financial impact to the extent that this can be made). This is likely to be relevant for many businesses with 31 March year-ends, as the closures and other public health measures taken in response to the COVID-19 pandemic would have already been in place on the relevant balance sheet date.

Material Adverse Effect

Estimates of how material the impact of closures and other public health measures taken in response to the COVID-19 pandemic has been on a business may be significant where the

relevant borrower is concerned about whether that impact may constitute a "Material Adverse Effect" for the purpose of the relevant event of default in its facilities agreement (usually a '*material adverse change*' event of default which will be triggered by the occurrence of an event which the lenders believe may have a "Material Adverse Effect").

However, it should be noted that there are various considerations which mean that lenders are generally unlikely to seek to rely upon "Material Adverse Effect" to trigger an event of default save as a last resort in extreme cases. In particular, English case law[1] has indicated that a change will only be considered '*material*' if it substantially affects the borrower's ability to perform its obligations in the underlying agreement and that the existence of external economic or market disruption would not of itself constitute a material adverse change.

FINANCIAL COVENANTS AND EXCEPTIONAL ITEMS

Exceptional Items

Many facilities agreements with financial covenants that reference EBITDA include a concept of "Exceptional Items". "Exceptional Items" are excluded from EBITDA and often defined (in line with the drafting of the LMA recommended form of leveraged facilities agreement) as any "*exceptional, one-off, non-recurring or extraordinary items*".

If costs, provisions, write downs, impairments or losses relating to the impact of the closures and other public health measures taken in response to the COVID-19 pandemic come within the definition of "Exceptional Items", this may benefit borrowers by mitigating the reduction in EBITDA that is likely to be experienced during testing periods ending between Q2 2020 and Q1 2021.

Extraordinary Items (FRS 102)

The term '*exceptional item*' is not defined for the purpose of FRS 102 (the accounting standard generally used in the UK and Ireland) but the term "extraordinary items" is defined in FRS 102 as follows:

"*Extraordinary items are material items possessing a high degree of abnormality which arise from events or transactions that fall outside the* ***ordinary activities*** *of the reporting entity and which are not expected to recur.*" ***[emphasis added]***

FRS 102 defines "ordinary activities" as follows:

"*Ordinary activities are any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities. Ordinary activities include any effects on the reporting entity of any event in the various environments in which it operates, including the political, regulatory, economic and geographical environments, irrespective of the frequency or unusual nature of the events.*"

The reference in the definition of "ordinary activities" to the "*effects on the reporting entity of any event in the various environments in which it operates*" does appear to be very wide-ranging. However, the closures and other public health measures taken in response to the COVID-19 pandemic do "*…[possess] a high degree of abnormality*" (as referred to in the definition of "extraordinary items" and, if the requirements set out in the definition of "extraordinary items" are not satisfied, the reference in the above LMA definition of "Exceptional Items" to "*one off or non-recurring items*" is likely to be sufficiently wide to cover losses or increased costs (such as redundancy or restructuring costs or the impairment of assets) resulting from an unprecedented pandemic event such as the COVID-19 pandemic.

Continuing losses/costs

However, if the relevant losses or increased costs continue for an extended period, it would be more difficult for borrowers to continue including them as an "Exceptional Item" once the initial impact is no longer included in the relevant '*look-back*' reporting periods. By way of example, situations have arisen (unrelated to the COVID-19 pandemic) where lenders have challenged whether events that occur every year or persist for a number of years can validly be treated as "Exceptional Items" given that they are recurring/persisting.

FACILITIES AGREEMENTS AND TREATMENT OF COVID-19 MEASURES

Grants and Wage Subsidy Schemes

Many businesses may benefit from government grants or wage subsidy schemes aimed at mitigating the impact of the closures and other public health measures taken in response to the COVID-19 pandemic.

It will, however, be necessary for those business to review the terms of their facilities agreements to confirm how these grants and schemes will be treated for the purposes of the definitions of "EBITDA" and "Cashflow" in facilities agreements. For example, "EBITDA" is derived from consolidated operating profit before taking account of "Exceptional Items" (which may include one-off '*positive*' receipts) whereas "Cashflow" will generally take account of cash receipts relating to Exceptional Items.

Loans and other Credit Support

Where businesses benefit from government support in the form of loans or other types of credit support, it may be necessary to amend the terms of their facilities agreements to ensure that this constitutes "Permitted Financial Indebtedness" and to determine whether this should be included in financial covenant calculations as to "Leverage" or "Loan-to-Value" tests.

Rental Income/Costs

Where borrowers have significant rental income or rental costs, any agreements reached by them with lessees or lessors in respect of rent-free periods or rent reductions may also affect performance of the business against financial covenants (this will differ depending on how the relevant financial covenant definitions have been drafted).

Payment Moratoria

Finally, many borrowers are currently availing of payment breaks offered by Irish retail banks to defer payments of interest and repayments of principal under their facilities agreements. Once these payment breaks roll-off, some of those borrowers are likely to need to agree financial covenant resets to allow for the double impact of reduced revenues until their businesses return to normal trading conditions, coupled with higher debt service costs as they '*catch-up*' with deferred interest and principal payments.[2]

1 Grupo Hotelero Urvasco SA v Carey Value Added SL [2013] EWHC 1039 (Comm).

2 For further information on those payment breaks, see our recent briefings: COVID-19: Payment breaks extended to six months and COVID-19: EBA Guidelines on Payment Moratoria.

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