

# MISCELLANEOUS TECHNICAL STATEMENT

## Firms' Reports and Duties to Lenders in Connection with Loans and Other Facilities to Clients and Related Covenants

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# **Firms' Reports and Duties to Lenders in Connection with Loans and Other Facilities to Clients and Related Covenants**

## **PREFACE**

This Statement, originally issued by the Consultative Committee of Accountancy Bodies and reproduced with their permission, provides guidance to assist firms to manage their duty of care in relation to banks and other lenders arising from an audit, or review, of the financial statements of a company prepared for statutory purposes. The Statement also provides guidance on reporting in connection with financial covenants in loan agreements and other facilities.

The guidance, which replaces Practice Note 4 'Reliance by Banks on Audited Financial Statements' issued by the Auditing Practices Committee, reflects experience and developments in the market place since Practice Note 4 was issued in 1991.

The guidance in this Statement is based on the present law governing duties of care. A major review of company law is currently in progress and, as and when the proposals arising from this review are enacted into law, this Statement may need substantial revision. However until such time as the law changes, the Statement gives guidance on the matters that should be considered by firms regarding the extent of their duty of care in respect of audit and review reports and ancillary reporting services in connection with loans and other facilities made available to their clients.

The guidance provides an authoritative summary of the relevant considerations but should not be regarded as a substitute for the specific legal and professional advice which firms may need to take on particular matters or engagements.

*The Statement is directly applicable in Northern Ireland. Certain detailed guidance has been added, in the exclusive context of the Republic of Ireland, to have regard to differing statutory requirements within that jurisdiction. All such changes are prefaced by the "ROI" symbol and are in italicised text.*

## FIRMS' REPORTS AND DUTIES TO LENDERS IN CONNECTION WITH LOANS AND OTHER FACILITIES TO CLIENTS AND RELATED COVENANTS

### INTRODUCTION

- 1 The responsibilities of auditors to third parties in respect of the statutory audit report are established in case law. The House of Lords in its judgment in *Caparo Industries Plc v Dickman* (1990) 2 WLR 353 sets out the essential ingredients by which the existence of a duty of care is to be recognised. *ROI : The Caparo decision has been applied in the High Court and may be followed by the Irish Supreme Court.*
- 2 In his judgment, Lord Bridge described the salient features of earlier cases, stating that for a duty of care to a third party to arise in respect of the advice or information given, the person who it is alleged owes that duty of care must be fully aware:
  - of the nature of the transaction contemplated by the third party;
  - that the advice or information given would be passed to the third party, directly or indirectly; and
  - that it was very likely that the third party intended to rely on that advice or information in deciding whether or not to engage in the transaction in contemplation.
- 3 In these circumstances, Lord Bridge considered that, subject to the effect of any disclaimer of responsibility, the person giving advice or information would be expected specifically to anticipate that the third party would rely on the advice or information given in deciding whether or not to engage in the transaction in contemplation.
- 4 Since the issue of the Caparo judgment, banks and other lenders have sought ways to document a direct and sufficient relationship between themselves and their customers' auditors so as to be able to rely on audit reports contained in financial statements prepared for statutory purposes.
- 5 This Statement gives guidance on the implications of such practices by lenders and the matters that should be taken into consideration by firms regarding the extent of their duty of care in respect of audit, review and other reports on financial statements which they may provide.
- 6 It also provides guidance on reports which firms may be requested to provide to lenders in connection with their clients' compliance with covenants and other conditions included in agreements for loans and other facilities.

### DUTIES OF CARE FOR THE STATUTORY AUDIT REPORT

- 7 Auditors would not normally expect to owe duties of care in respect of their audit report to anyone other than their audit client. However, the general trend of authorities since Caparo makes it clear that, unless there is an effective disclaimer, an auditor may owe a duty of care to a lender or other third party. The test is whether the auditor, in making the statements in the audit report, assumed a responsibility to a lender who may have been provided with those statements. This test is an objective one: it is not whether the particular auditor intended to assume such a responsibility, but whether a reasonable auditor in those circumstances would have assumed such a responsibility.
- 8 Whether a duty of care to a lender exists will depend upon all the circumstances. The following factors will, however, be relevant:
  - the precise relationship between the auditor and the lender;
  - the precise circumstances in which the audit report came into existence;
  - the precise circumstances in which the audit report was communicated to the lender, and for what purpose(s), and whether the communication was made by the auditor or a third party (such as the client);

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- the presence or absence of other advisers on whom the lender would or could rely;
- the opportunity, if any, given to the auditor to issue a disclaimer.

- 9** Accordingly, auditors need to be alert to the possibility that circumstances may be such that, unless steps are taken to limit their exposure, they may, however inadvertently, have assumed responsibility and, therefore, a duty of care, to a lender for the statements in their audit report. This may result from events contemporaneous with the audit, such as the client's discussions with the lender, or from events subsequent to the audit, such as a request for sight of the most recent audited accounts. For this reason, the auditors' relationship with lenders needs to be managed carefully, using established risk management techniques, and clear statements defining the auditors' duties, if any.
- 10** In seeking to document a sufficient relationship so as to enable them to rely on the audited financial statements of their customers, certain banks have included a clause in the conditions precedent to the granting of loan facilities which seeks to require the auditor of the borrower to provide written acknowledgement to the bank that, in connection with the facilities offered, the bank may rely on the audited financial statements of the borrower. An example of such a clause is as follows:
- “The bank shall have received written acknowledgement from the borrower's auditor that in connection with the facilities or any increase or extension thereof the bank may, with the auditor's knowledge and consent, rely on the audited financial statements of the borrower (and the group) from time to time made available to the bank, directly or indirectly, in connection with the bank's assessment and monitoring of the financial condition of the borrower (and the group) and compliance with the terms and conditions of the agreement.”
- 11** Whether a duty of care to a bank arises in fact will depend upon whether the criteria set out in paragraph 2 above are met. Nevertheless, auditors in receipt or aware of a request to provide acknowledgement of their responsibility to their client's bankers or other lenders should not allow it to go unanswered.
- 12** In addition to, or as part of, a notification which seeks to establish an ongoing duty of care, a duty in respect of a lending decision might also be established if the lenders write to a firm expressing their intention to rely on audited or reviewed financial statements in connection with a proposed transaction. The presumption in such a situation would be that the firm had accepted that it had a duty of care to the lender unless it had robustly denied it. Should the firm wish to disclaim responsibility to the lender, as would normally be the case, it should state this expressly in writing. An example of a response which might be appropriate and can be customised to the circumstances of the lender's notification is provided in Appendix 1.

Where a firm is contemplating signing a statement containing a specific undertaking or form of words provided by the lender (rather than responding along the lines of Appendix 1), it should consider obtaining legal advice regarding the consequences for its legal responsibilities to the lender of complying with such a request and discuss its proposed response with its client.

### **Draft accounts**

Care needs to be taken in relation to the provision and circulation of draft audited or reviewed accounts to lenders prior to the report being signed. Whilst the courts have held that reliance upon draft audited accounts was not actionable because a reasonable auditor would not intend such reliance, nevertheless there may be circumstances in which a duty of care could arise based on statements in draft accounts. Accordingly, the status of the accounts needs to be stressed, and representations and assurances as to the reliability of the accounts, or whether the final position is likely to differ materially from that shown in the draft accounts, should be avoided.

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### **Disclaimer of responsibility**

- 15** Disclaimers of responsibility will be subject to a test of reasonableness set out in section 2 of the Unfair Contract Terms Act 1977. It is for a person seeking to rely upon the disclaimer to show it is reasonable, failing which it will be void. Disclaimers of responsibility to lenders (and other third parties) who seek to claim reliance on a report, and disclaimers made for the avoidance of doubt to confirm that a firm does not accept a duty to a lender or other third party to whom a report is shown or reference to a report is otherwise made, should be capable of being worded so as to pass the reasonableness test. Consequently they are an effective method of excluding or limiting a firm's liability to a lender or other third party. *ROI : There is no direct equivalent of the 1977 Act in the Republic of Ireland, nor is there any general Irish statute on exclusive clauses.*
- 16** Issuing a disclaimer of responsibility does not remove a firm's obligation to carry out the audit or review of the financial statements in accordance with Auditing Standards (or other applicable standards) and it should therefore plan, control and record its work appropriately.

### **The Contracts (Rights of Third Parties) Act 1999**

- 17** The Contracts (Rights of Third Parties) Act 1999 came into force on 11 November 1999 and applies to all contracts entered into after 10 May 2000. Under the Act, third parties have the right to enforce a term of a contract if that is the intention of the parties, which intention shall be determined from the contract. An intention will be found if, upon proper construction, the contract purports to confer a benefit or an express term grants the right. *ROI : There is no equivalent Irish legislation to the 1999 Act. The common law principle of privity of contract applies in the Republic of Ireland - the general rule is that only a person who is party to a contract can enforce it.*

Accordingly, if under the engagement between the firm and the client reference is made to the provision of the accounts to a lender, or to a lender requiring the accounts for specific purposes, it is conceivable that a benefit will have been conferred upon that lender. Furthermore, in considering the reasonableness of any exclusion of liability to that lender, any such provisions will be taken into account, which has the potential of defeating any such exclusion in its entirety. It is therefore important that the engagement letter between the firm and the client makes clear that it does not confer any rights on any third party and that, for the avoidance of doubt, any rights conferred on third parties pursuant to the Contracts (Rights of Third Parties) Act 1999 shall be excluded.

### **Separate engagements to provide specific assurances to lenders**

- 20** If a firm decides that it is able and prepared to provide specific assurances to a lender regarding, for example:
- financial statements where the audit or review report has been signed or will be signed in the near future;
  - the design and/or operation of the client's systems of internal control or the financial reporting procedures; or
  - other matters of primary interest to a lender,

they should be the subject of an engagement between the firm, the client and the lender which is entirely separate from the work on the financial statements and is the subject of a separate engagement letter and separate fee arrangements as agreed between the parties for whom the engagement is carried out.

## **FIRMS' REPORTS AND DUTIES TO LENDERS IN CONNECTION WITH LOANS AND OTHER FACILITIES TO CLIENTS AND RELATED COVENANTS**

- 21** Before a firm enters into such an engagement to provide specific assurances to a lender to a client, it should consider its position carefully in the light of the Accountancy Bodies' ethical statements since its responsibilities to the client and the lender could, in certain circumstances, present it with a conflict of interest. The same consideration applies when a loan agreement purports to appoint the firm as agent for, or financial advisers to, the lenders for the purpose of providing services and reports in connection with a loan agreement, facility or drawdown.
- 22** The firm should also consider professional guidance in deciding the scope and terms of business of any engagement to provide specific assurances to a client's lenders.

### **Duties of care for non-statutory audits or reviews**

- 23** Companies which take advantage of the exemption from the statutory audit requirement available to them by virtue of their small size may nevertheless decide to have their financial statements independently audited or reviewed for other purposes. Such reports will not be on the public record and the firm will generally include a restriction on use in its report, requiring its prior written consent before the report can be made available to any third party. However if a 'small' company chooses not to take advantage of the exemption and continues to have a statutory audit, the audit report will be filed at Companies Registration Office/Companies Registry with the statutory accounts and the duties of care of the firm which undertakes the audit will be the same as those discussed in paragraphs 7 to 13 above.
- 24** If a firm undertakes an audit or review engagement of financial statements other than on express terms that the purpose of the engagement is to provide a report which will be made available to and relied upon by a lender to the client, the firm will wish to avoid subsequently incurring a duty of care to the lender in respect of the report. Accordingly, the firm will usually only consent to its report on the financial statements being made available to the lender if the lender acknowledges in writing that the report is provided for information purposes only and does not give rise to any responsibility, liability, duty or obligation whatsoever from the firm to the lender. Similar considerations apply and an acknowledgement from the lender in equivalent terms will usually be required by a firm which, while not providing an audit or review report, has assisted a client with the compilation of financial information which is to be made available to a lender.
- 25** If a firm decides to accept an audit or review engagement of financial statements on the express understanding with the client and a lender that its report will be made available to and relied upon by the lender, the firm is unlikely subsequently to be able to avoid assuming a duty of care to the lender in respect of the report. It is a commercial and risk management decision for the firm as to whether to accept such an engagement and it may wish to take legal advice before doing so.
- 26** Where an engagement likely to result in a duty of care to a lender is accepted, the firm will wish to put the limitations of that duty into context by obtaining the lender's written acknowledgement of an engagement letter which sets out (inter alia):
- (a) the objective of the firm's work (e.g. to provide a report to the company giving a specified form of assurance as to whether in the firm's opinion the financial statements give a true and fair view in accordance with Financial Reporting Standards as set out in the Financial Reporting Standard for Smaller Entities or other relevant accounting standards).
  - (b) that users of financial statements should be aware that there are inherent limitations in any set of financial statements. The limitations of audited financial statements include the matters listed below; similar limitations are broadly applicable to reviewed financial statements but the illustrative wording below may need modification or amplification to reflect the circumstances of the review:

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- financial statements present a company's state of affairs only at the balance sheet date and an historical view of the company's results for the period then ended;
  - financial statements must be interpreted having careful regard to the underlying accounting policies;
  - financial statements may not reflect items which are considered to be immaterial;
  - certain revenues, costs, assets and liabilities, for which no precise means of measurement exist, may be included in the financial statements on the basis of the directors' best estimates;
  - events that have occurred between the balance sheet date and the date of the audit or review report will only be reflected in the financial statements in so far as they relate to the period being reported on;
  - although financial statements are normally prepared on a going concern basis, they do not give any indication of the level of future profitability or cash flows of the business or guarantee that the business will remain financially viable.
- (c) that the extent to which a lender may rely on a company's financial statements in connection with its assessment and monitoring of the financial condition of that company may depend on the effect of the inherent limitations set out above and whether:
- the accounting policies adopted by the directors as a basis for preparing the financial statements are appropriate for the lender's purposes;
  - the lender's assessment of the financial condition of the company is being undertaken sufficiently near to the balance sheet date for reliance on the financial statements to be meaningful;
  - it is necessary to obtain more up to date financial information from the company's directors regarding current trading and future projections of results and cash flows;
  - additional information is required from the company's directors in order to assess whether the company has complied with the terms and conditions of a lending agreement;
  - there are any other matters in which the lender may be primarily interested as a lender.
- (d) that accordingly, the decision as to whether to enter into or continue with a lending transaction is solely that of the lender and a firm's audit or review work does not in any way constitute a recommendation as to what decision the lender should take or supplant the enquiries and procedures that the lender should undertake in its consideration of that decision.

**Covenants in agreements for loans and other facilities**

- 27** The agreements documenting certain financial instruments, including for example facility agreements supporting bank lending, often contain a number of covenants with which the borrower is expected to comply. These are more common in term loans and other committed facilities which are not repayable on demand. Compliance with such covenants is intended to help assure the lender of the continuing security for the advance. Failure to comply would be regarded as a breach of covenant and would normally be dealt with as an event of default under the loan facility agreement.



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- 28** Covenant clauses are most commonly encountered in loan facility agreements and debentures, but similar clauses are often included in the terms of other types of financial instruments. The precise nature of the financial instrument does not affect the applicability of this guidance to a firm's responsibilities or reports in connection therewith. The principles underlying the guidance are relevant to any report in connection with the assessment of compliance with covenants or conditions contained in a commercial agreement. They are also relevant to reports relating to audited financial statements required by regulatory bodies, trade associations and other third parties.
- 29** Covenants contained in loan agreements can pertain to a variety of financial and non-financial information relating to the borrower's financial condition and actions. These covenants normally comprise a series of general covenants together with a number of detailed clauses tailored to the specific circumstances of the borrower. Typically, the directors of the borrower are required to prepare a periodic statement, report or representation to the lender confirming compliance with the terms of the loan agreement. Such statements, reports or representations are hereinafter referred to in this Statement as 'Statements of Covenant Compliance'.
- 30** The more routine non-financial covenants in such agreements record commitments by the borrower as to its future actions. For example:
- to provide information to the lender, (for example monthly management accounts, audited accounts etc.) within a specified period;
  - to continue to insure assets, maintain and develop the business, to comply with laws and regulations; and
  - not to sell or charge substantial assets or dispose of parts of the business, without the lender's consent.

In addition to these non-financial covenants, the lender often will require the borrower to maintain certain financial statement ratios, (e.g. gearing, interest cover, etc). The imposition of these financial covenants is intended to provide the lender with some assurance as to the continuing financial condition of the business and its progress in accordance with the information provided to the lender at the time of initial advance.

Examples of the subject matter of the more common financial and non-financial covenants for borrowings are set out in Appendix 6. In specialised industries, the scope of such covenants may be extended to the maintenance of key operating statistics or key performance indicators ("KPIs") which are derived from management information outside the audited financial statements.

### **THE REQUIREMENT FOR AND ACCEPTANCE OF ENGAGEMENTS**

#### **TO REPORT ON COVENANT COMPLIANCE**

##### **The lenders requirement for evidence of covenant compliance**

- 33** The borrower's commitment to comply with the covenants at all times is evidenced in the loan agreement which will normally also provide for specified financial covenants to be tested at intervals (e.g. quarterly, six monthly or annually). Typically the lender will require a written confirmation from the directors that they have complied with the covenants for the period under review. This is usually contained in or supported by a Statement of Covenant Compliance prepared by the directors at each period end confirming and setting out the computation of the relevant financial covenants for the applicable date and period.



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- 34** The lender will seek to obtain some assurance that these calculations are reliable. Simple calculations of gearing and interest cover based upon audited or management accounts are usually self evident and the lender can recalculate the financial ratios itself. However, the basis of calculation of compliance with KPI based covenants may not be self evident from the accounts, as the underlying information may be drawn from sources within the company concerned.
- 35** It is customary for the lender to include in the loan agreement a provision for a report to be received from the borrower's auditors relating to the directors' Statement of Covenant Compliance. The requirement for this report and its subject matter is normally negotiated directly between the lender and borrower as part of the facility terms and set out in the loan agreement itself. Typically this requirement is expressed only in general terms; the nature of the report often is not clearly specified in the agreement but firms may expect it to extend to the calculation or extraction of the financial information which form the basis of the covenant compliance calculations and to the accuracy of the calculations themselves.
- 36** Firms are not obliged to accept an engagement to report in connection with a client's borrowing facilities, whatever the express provisions of the loan agreement, since they cannot be bound to comply with the terms of an agreement to which they were not party. However, situations where firms find themselves unable to report in the required terms are obviously best avoided if possible. Consequently, if a firm becomes aware that a client is involved in a loan or other facility negotiation, it is good practice for it to enquire into whether the draft loan agreement seeks to place any duties or reporting obligations on it and to advise whether the covenants are capable of subsequently being reported upon.
- 37** Representatives of The City of London Law Society, whose members are regularly engaged in the drafting of loan agreements, have confirmed 1) that they recognise that it is important that covenants in lending documentation relating to auditors' reports should subsequently be able to be complied with, and 2) that a well-advised borrower would therefore only agree to requirements for reports by its auditors if this was cleared with the firm or if the borrower was otherwise sure that the firm would be able to provide the relevant report and in full knowledge of the costs which may be incurred.
- 38** When a firm becomes aware of references in loan agreements to reports required of it in relation to covenant compliance (and particularly if it receives direct communications from the lender seeking to assert the basis on which it intends to rely on such reports), it should, for the avoidance of doubt, consider responding to the lender setting out the basis on which it will be prepared to report. An example of such a letter where a firm acts as auditor is in Appendix 2.

**The firm's duty of care when reporting on the directors' statement of covenant compliance**

- 39** In accepting an engagement to report to lenders on the extraction and compilation of the financial covenants, a firm acknowledges a duty of care to the lender in relation to the subject matter of its report on the directors' Statement of Covenant Compliance.
- 40** Firms use established risk management techniques to control the duties of care in relation to the subject matter of their report, for example by entering into an engagement letter with the addressees of the intended report, which restricts the use of the report to them, specifies liability limitations and includes a disclaimer of responsibility to any other person.

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However, it is possible that in the specific circumstances of an engagement, for example to report upon information to be extracted from the audited or reviewed financial statements, firms might be found to have (perhaps unintentionally) assumed responsibility to the lenders for an audit or review report (a duty of care which, but for the report in connection with covenant compliance, would not otherwise have existed). Consequently, and for the avoidance of doubt, firms will normally include in their terms of engagement for reporting on the directors' Statement of Covenant Compliance an express disclaimer of any duty of care to the lenders in respect of their audit or review report.

### The firms' consideration of acceptance of the engagement

- 42 Reports by firms on a directors' Statement of Covenant Compliance are normally provided as an ancillary service to the audit or review of the borrower's financial statements and are conducted under a separate engagement letter and fee arrangements. The engagement could take the form of an assignment to report to the directors to provide them with assurance in connection with the discharge of their responsibilities. Such a report might be relevant where there is no requirement from the lender for an independent report. More commonly, however, the engagement would require a report to the lender on the extraction and compilation of the financial information in the Statement of Covenant Compliance
- 43 In deciding whether to accept the engagement, firms need to ensure that the reporting structure reflects an appropriate delineation between the clients' responsibilities to provide financial information to the lender and the firm's responsibility to report upon it. It is the directors' responsibility to prepare the financial information supporting their assertion that they have complied with the terms of the loan agreement. The firm's responsibility should be to report upon that information to the extent that it relates to financial and accounting matters.
- 44 The directors will prepare their Statement of Covenant Compliance in accordance with their responsibilities under the loan agreement. The Statement would normally set out the calculations of financial ratios etc. as provided for in the loan agreement. The Statement may deal separately with the non-financial covenants often in terms of a negative statement (e.g. that there have been no breaches of the covenants set out in Clauses [ ] to [ ]). Alternatively the Statement may recite each such covenant individually.
- 45 The loan agreement will usually require the borrower to comply with the covenants at all times. The firm's report will relate to financial covenants by reference to financial information as of specified dates and periods. Firms will not normally accept an engagement in which they are to provide wide-ranging assurance that the borrower has complied or is in compliance with the covenants contained in the agreements or that, based on prospective financial information, the borrower will be in compliance with the covenants for a future period. The scope of their engagement will usually be confined to reporting the results of applying specified procedures to financial information in the Statement of Covenant Compliance, where such information is objectively ascertainable.

Before accepting the engagement the firm needs to be sure that the matters on which it is asked to report are clear, unambiguous and appropriate in the circumstances. Firms should consider carefully the implications of accepting an engagement to report on a Statement of Covenant Compliance based on financial covenants whose terms are imprecise, require subjective interpretation beyond the scope of recognised accounting expertise or are based upon data extracted from records outside the borrowers' system of internal financial control. Examples of such difficulties are where a firm is required to report on a Statement of Covenant Compliance 'after making such adjustments as they consider necessary' or 'immediately after' the occurrence of an event or transaction which may not coincide with a date at which accounts are prepared. Where ambiguity, imprecision or subjectivity is capable of being resolved by agreement between the parties, the firm should seek the joint written instructions of its client and the lender as to how the financial covenant concerned is to be interpreted before undertaking the engagement.

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### **Client confidentiality**

Firms will need to ensure that the client authorises them to comply with the request. Notwithstanding the terms of any loan agreement, they have a duty of confidentiality to their client. Consequently, they cannot agree to report on client confidential information without the prior agreement of their client, which should be obtained in writing.

### **Engagement letter**

- 48** Firms will need to consider whether the request is a separate engagement, whether directly between the lender and themselves or a further engagement between the client and themselves. A separate engagement letter normally will be required unless the provision of the report was specifically contemplated in another such engagement letter addressed to the relevant parties. (An example engagement letter where a firm acts as auditor is in Appendix 3).

## **SCOPE OF THE WORK AND THE REPORT**

### **Scope of the work**

- 49** The precise scope of work will need to be agreed with the client and the lender to reflect the specific circumstances. Typically the firm would:
- (1) read the relevant clauses of the loan agreement and understand the operation of the relevant covenants to the extent they pertain to accounting matters;
  - (2) read the directors' Statement of Covenant Compliance;
  - (3) agree the financial information in the Statement to the sources from which it has been extracted;
  - (4) recompute the calculations and ratios set out in the directors' Statement with the objective of confirming their arithmetical accuracy;
  - (5) obtain representation from the client to the completeness of disclosure in the Statement. An example representation letter is provided in Appendix 4.
- 50** The firm will report on accounting, financial and quantitative matters which are within the scope of its professional expertise. It does not provide comment on matters to which its skill or experience has little or no relevance or application.
- 51** Normally firms do not undertake procedures to confirm the reliability of financial information in the Statement nor of the sources from which the data has been extracted. Equally, they do not report on non-financial information or on matters primarily involving the exercise of the directors' business judgement, for example explanations of operating trends (to the extent that the directors are required by a covenant to provide such explanations) since these may depend on factors beyond their expertise. Consequently, the firm's report in connection with covenant compliance will normally be confined to the accuracy of the extraction and computation of those financial matters which are the subject of covenants within the facility and only to the extent they are capable of clear definition, relate to accounting matters and are extracted from records within the borrower's system of internal financial control.

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- 52** In view of the limited nature of these procedures, firms would not be expected to provide assurance as to judgemental matters, such as fair presentation in accordance with the loan agreement or to report on the extraction of, or underlying procedures relating to, non-financial information, without undertaking a substantive engagement designed for that purpose which is beyond the scope of this Statement.

As noted in paragraph 41 above, when a firm reports on a directors' Statement of Covenant Compliance it will normally disclaim any duty of care to the lender in respect of any audit or review report it has given on the borrower's financial statements. In any event, the period to which a Statement of Covenant Compliance relates will not necessarily correspond with a period for which an audit or review has been performed. If the periods do coincide, and the firm's report on the financial statements has been modified or qualified in respect of matters which could have a material effect on the Statement of Covenant Compliance, the firm will consider its position accordingly.

### **The report**

- 54** The firm's report should be prepared in accordance with the engagement letter. The report will normally:
- (1) identify the addressees who can rely on it;
  - (2) contain a statement as to the scope of the report and the respective responsibilities of the directors and the firm;
  - (3) refer to the Statement of Covenant Compliance prepared by the directors in accordance with the loan agreement;
  - (4) set out the basis for the report;
  - (5) provide a description of the procedures undertaken, either in the body of the report or in an appendix;
  - (6) report as to the arithmetical accuracy of the extraction and calculation of the financial information contained in the Statement; and
  - (7) where the elements and composition of the financial information contained in the Statement are the subject of objective accounting definition in the loan agreement or have been subsequently agreed by the parties, report whether the financial information is presented in compliance with the relevant definitions and agreement.

An illustrative form of report is provided in Appendix 5.

### **Liability protection**

Firms would expect to exclude liability in respect of any loss or damage caused by, or arising from, fraudulent acts, misrepresentation or concealment on the part of the client entity, its directors, employees or agents. They would also exclude liability to third parties. They would expect to agree a limitation of their liability to the lender and the client which was appropriate to the limited scope of the engagement. References to such clauses are contained in the example engagement letter at Appendix 3.

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**APPENDIX 1 – Example disclaimer of responsibility to lenders for audit or review reports**

(Guidance reference: paragraph 12)

[Lender plc]

Dear Sirs,

**Client plc - [Loan Agreement/Transaction Reference]**

We acknowledge receipt of your letter of [...date...] in which you state your intention to rely on the financial statements of Client plc for the year ended [...date...] and our audit [or review] report thereon [in connection with the above mentioned loan agreement].

Our audit [or review] of the financial statements [was/is] neither planned nor conducted for the purpose of (or in contemplation of) the loan agreement (and transaction) referred to above. In particular, the scope of our work [was/is] set and judgments made by reference to our assessment of materiality in the context of the financial statements taken as a whole, rather than in the context of your needs. For this reason, our work would not necessarily [have addressed/address] or reflect[ed] matters in which you may be primarily interested as lenders. Therefore, we cannot accept any responsibility to you in relation to our report and disclaim all liability to you in connection therewith (and your lending decision in relation to the proposed transaction and any other actions you may take).

Should you require any specific assurances from us regarding any matters in which you may be primarily interested as a lender, we should be happy to discuss them with you in the context of an engagement between ourselves, Lender plc and Client plc which would be entirely separate from our audit [or review] of Client plc's financial statements.

Yours faithfully,

cc Client plc

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**APPENDIX 2 – Example letter to lender setting out basis on which reports  
under loan agreements will be provided**

(Guidance reference: paragraph 38)

[Lender plc]

Dear Sirs

**Client plc - [Loan Agreement Reference]**

Client plc has provided us with a copy of [and you have written to us in connection with], the Loan Agreement referred to above, Clause X of which contemplates that reports will periodically be provided to you by the auditors of Client plc in connection with Client plc's compliance with certain covenants.

As auditors of Client plc, we confirm that, provided that Client plc authorises us to do so and you sign an engagement letter with us substantially in the attached form, we will report to you on the following matters:

- 1) whether the financial information contained in the Statement of Covenant Compliance prepared by the directors of Client plc has been accurately extracted from the sources identified therein and, where applicable, agrees with the underlying accounting records;
- 2) whether the calculations shown in the Statement made in accordance with Clause [ ] of the Loan Agreement are arithmetically accurate; and
- 3) where the elements and composition of the financial information contained in the Statement are the subject of objective accounting definition in the Loan Agreement, or have subsequently been agreed by Lender plc and Client plc, whether the financial information is presented in compliance with the relevant definitions and agreement.

As regards our audit work on Client plc's financial statements for future periods, our work will be carried out in accordance with our statutory and professional obligations and will not be planned or conducted in contemplation of your requirements or any matters which might be set out in the Loan Agreement. In particular, the scope of our audit work will be set and judgments made by reference to our assessment of materiality in the context of the audited accounts taken as a whole, rather than in the context of your needs. For this reason, our work will not necessarily address or reflect matters in which you may be primarily interested as lenders. Therefore, we cannot accept any responsibility to you in relation to our audit opinions and disclaim all liability to you in connection therewith.

Yours faithfully

cc Client plc

Attachment: Form of engagement letter

## FIRMS' REPORTS AND DUTIES TO LENDERS IN CONNECTION WITH LOANS AND OTHER FACILITIES TO CLIENTS AND RELATED COVENANTS

### APPENDIX 3 – Example engagement letter

(Guidance reference: paragraph 48)

[Lender plc]

[Other addressees as provided for in the second paragraph of the letter]

Dear Sirs

#### **Client plc - [Loan Agreement reference]**

Under the terms of Clause [ ] of the agreement dated [ ] between Client plc and Lender plc (the 'Loan Agreement'), the Directors of Client plc are required to procure that their auditors report to you in connection with the Directors' Statement of Covenant Compliance, (the 'Statement'), prepared in accordance with Clause [ ] of the Loan Agreement. At the request of the Directors of Client plc, we are writing to set out our understanding of the work you wish us to perform and the terms and conditions upon which we are prepared to provide such a report for your use. A copy of this letter is being sent to the Directors of Client plc to confirm their authorisation and understanding of the basis on which we will report to you.

[This engagement letter is addressed to Lender plc, as lead manager/arranger of the facility/syndication agreement, and to each of the other lenders participating in the facility/syndication agreement whose names, as set out in Attachment 1, have been notified to us by Lender plc as having validly authorised it to accept this engagement letter on their behalf. By signing and accepting the terms of this engagement letter, Lender plc confirms that it will ensure that it receives prima facie authority from each other lender identified in Attachment 1 as participating in the facility/syndication agreement authorising it to enter into this engagement letter on the relevant lender's behalf.]

#### **Respective responsibilities of directors and auditors**

The directors of Client plc are responsible for ensuring that Client plc complies with all of the terms and conditions of the Loan Agreement including each of the Covenants set out in Clauses [ ] to [ ] thereof. Under Clause [ ] thereof, the Directors are responsible for preparing their Statement of Covenant Compliance. Our responsibility is to prepare a report to you on the computation of those financial covenants which pertain to accounting matters as identified below.

We are auditors of Client plc and have audited the annual accounts of Client plc, (the 'audited accounts') and reported to its members in accordance with our responsibilities to them under the Companies Acts on [ ] 200Y. Our audit of the accounts of Client plc was not intended to address compliance with financial covenants or other matters in which the addressees of this letter may be primarily interested. In particular, the scope of our audit work was set and our judgments made by reference to our assessment of materiality in the context of the audited accounts taken as a whole, rather than in the context of the report contemplated in this letter. Accordingly, we do not acknowledge any responsibility, and deny any liability, to the addressees of this letter in relation to the audited accounts.

#### **Basis of report**

Our work will be conducted in accordance with the framework for reporting in connection with loan covenants set out in guidance issued by the Consultative Committee of Accountancy Bodies and published as [*Miscellaneous Technical Statement* [xx] by the Institute of Chartered Accountants in Ireland]. We will read the Statement prepared by the Directors. Our work will be based on obtaining an understanding of the compilation of the Statement by enquiry of management, reference to the Loan Agreement, comparison of the financial information in the Statement to the sources from which it was obtained and recomputation of the calculations in the Statement. [The specific procedures which we have agreed to conduct are set out in the Appendix to this letter.] Other than as set out herein,



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we will not carry out any work by way of audit, review or verification of the financial information nor of the management accounts, accounting records or other sources from which that information is to be extracted for the purpose of providing you with our report.

**Use of report**

Our report will be provided solely for your use in connection with the Loan Agreement and should not be made available to any other party without our written consent. The report is confidential to you and will be provided only for the purpose of your assessment of Client plc's compliance with the terms of Clause [ ] of the Loan Agreement. We accept no liability to any other party who is shown or gains access to our report.

**Obligations and Liabilities**

We undertake that we will exercise reasonable professional skill and care in the performance of our work as set out in this letter in accordance with applicable professional standards. This engagement is undertaken subject to certain terms excluding liability where information is or has been misrepresented to us, or withheld or concealed from us, and providing for our aggregate liability to the addressees of this letter and Client plc to be limited to a maximum aggregate amount of £[ ] and subject to that cap, to the part of any loss suffered which is proportional to our responsibility.

It is agreed that the allocation between addressees of the limit of liability specified above will be entirely a matter for the addressees, who shall be under no obligation to inform us of it, provided always that if (for whatever reason) no such allocation is agreed, no addressee shall dispute the validity, enforceability or operation of the limit of liability on the ground that no such allocation was agreed.

Our detailed Terms of Business are set out in the attachment to this letter which shall apply as if set out in full herein.

**Acknowledgement and acceptance**

We will be grateful if, having considered the provisions of this letter together with the attachments and having concluded that they are reasonable in the context of all the factors relating to our proposed engagement, you will indicate your agreement to these arrangements by signing and returning to us the enclosed copy of this letter.

Yours faithfully

The terms and conditions contained in this letter and the attached Terms of Business (*where appropriate*) are agreed and accepted on behalf of Lender plc by:

.....  
Signature of Authorised Person

Authorised and accepted on behalf of Client plc by:

.....  
Signature of Authorised Person

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## **APPENDIX 4 – Example representation letter from client**

(Guidance reference: paragraph 49)

[Auditors]

Dear Sirs

### **[Loan Agreement Reference]**

In connection with your proposed report in accordance with the arrangements set out in your letter of [ ], we are writing to confirm to the best of our knowledge and belief the following representations we have made to you and on which you need to rely in providing your report on the Statement of Covenant Compliance, (the 'Statement'), to Lender plc.

- 1 We are responsible for preparing the Statement accurately reflecting the matters contained therein at the relevant dates.
- 2 The Statement is complete and accurate and reflects all matters of significance relating to Lender plc's assessment of Client plc's compliance with the Covenants set out therein as at the relevant dates and all significant matters relevant to that assessment have been brought to your attention.
- 3 Throughout the period since [ ] the Company has at all times been in compliance with the terms of the Loan Agreement or, if not, all such instances of non-compliance have been notified to Lender plc in accordance with the terms of the Loan Agreement. Copies of such notifications have been made available to you.
- [4 No events have occurred subsequent to [date of last audited financial statements] that would have required adjustment to, or disclosure in, the audited financial statements had their approval by the Board been deferred until the date of this letter.]

Yours faithfully

.....

Signature of Authorised Person on behalf of Client plc

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## **APPENDIX 5 – Example report**

(Guidance reference: paragraph 54)

[Lender plc]

[Other addressees as provided for in engagement letter]

Dear Sirs

### **Client plc - [Loan Agreement reference]**

We refer to the above mentioned agreement (the 'Loan Agreement'). Under the terms of Clause [ ] thereof, Client plc is required to comply with specified financial covenants and to supply the addressees of this letter with information in connection therewith reported upon by its auditors.

The directors of Client plc have prepared a Statement of Covenant Compliance, (the 'Statement'), a copy of which is appended to this letter.

This report letter is provided pursuant to, and must be read in conjunction with, our engagement letter dated [200Y] and is subject to the terms and limitations set out therein.

### **Basis of report**

Our work was conducted in accordance with the framework for reporting in connection with loan covenants set out in guidance issued by the Consultative Committee of Accountancy Bodies [and published as *Miscellaneous Technical Statement* [xx] by the Institute of Chartered Accountants in *Ireland*]. We have read the attached Statement prepared by the Directors. Our work was based on obtaining an understanding of the compilation of the Statement by enquiry of management, reference to the Loan Agreement, comparison of the financial information in the Statement to the sources from which it was obtained and recomputation of the calculations in the Statement. [The specific procedures we performed are set out in the Appendix to this letter.] For the purpose of providing you with this letter, other than as set out herein, we have not carried out any work by way of audit, review or verification of the financial information nor of the management accounts, accounting records or other sources from which that information has been extracted.

### **Report**

Based solely on the procedures described above, we confirm that:

- 1) the financial information contained in the accompanying Statement has been accurately extracted from the sources identified therein and, where applicable, agrees with the underlying accounting records;
- 2) the calculations shown in the Statement made in accordance with Clause [ ] of the Loan Agreement are arithmetically accurate; and
- 3) the financial information in the Statement is presented in compliance with the relevant accounting definitions as to its elements and composition set out in Clause [ ] of the Loan Agreement [and as agreed between Lender plc and Client plc and confirmed to us in a letter dated 200Y].

Our report as set out herein is confidential to the addressees of this letter and should not be made available to any other party without our written consent. It is provided solely for the purpose of your assessment of Client plc's compliance with the terms of [Clause [ ] of] the Loan Agreement. We accept no liability to any other party who is shown or gains access to this letter.

Yours faithfully

cc Client plc

## FIRMS' REPORTS AND DUTIES TO LENDERS IN CONNECTION WITH LOANS AND OTHER FACILITIES TO CLIENTS AND RELATED COVENANTS

### APPENDIX 6 – Common covenant restrictions and ratios

(Guidance reference: paragraph 32)

Examples of the subject matter of more common financial and non-financial covenants for borrowings are set out below.

#### Accounting-based

Cash flow to total debt service  
Dividend cover  
Minimum share capital and reserves  
PBIT-based interest cover  
Gearing  
Cash flow-based interest cover  
Other interest cover  
Net current assets/borrowings  
Proportion of debtors below certain days outstanding  
Current ratio  
Quick asset ratio  
EBITDA  
Gross profit margin  
Rent roll ratios

#### Non-accounting based

First charge over specified assets  
Audited annual accounts within specified period  
Cross default clauses  
Monthly management accounts within specified period  
Restrictions on changes to ownership  
Restrictions on additional borrowings (from other sources)  
Maintenance of adequate fire, theft and other insurances  
Restrictions in mergers/acquisitions  
Restrictions on asset disposals  
No capital expenditure beyond certain limit without approval  
Compliance with environmental laws and regulations  
Compliance with other laws and regulations  
No redemption of preference shares while loans outstanding  
Charges over keyman insurance  
Keyman critical illness policy  
Limits on director's remuneration