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Legal update ——— March 2014

Banking and Finance
Introduction of FRS102 – loan agreement issues

For most housing associations, the new financial year on 1 April 2014 brings with it the first steps towards the implementation of FRS102.

Housing associations with a 31 March year end will be obliged to restate their opening balance sheet as at 1 April 2014. This will enable these RPs to produce a prior year comparison in the first set of accounts produced under the new rules.

This article looks at how the introduction of FRS102 will affect obligations under your loan agreement(s) and what you can do to stay in compliance with them.

What are financial covenants for?

A good starting point is to consider the underlying purpose of the financial covenants found in most loan agreements.

They are designed to measure a borrower's actual financial performance. Any accounts, including those that will be produced under the new regime, can only be an indicator of performance, albeit one of the closest possible indicators available to a lender.

Specifically, financial covenants are designed to measure a borrower's ability to service and repay its loan. This is all about the ability to generate sufficient cash at the times required.

The move to FRS102 will not affect actual financial performance or a borrower's cash position so fundamentally lenders should not be concerned about it, except to ensure consistency of reporting.

The move to FRS102 should also not upset the agreed commercial deal.

What loan agreements have to say about financial covenants and accounting change

Every loan agreement is different and what follows is a summary of the usual kind of provisions that are typically found in this area. However, there is no substitute for reviewing every one of your loan agreements to see the exact provisions that apply in each case.

Most loan agreements will contain an obligation to:

- produce accounts and other financial information on a consistent basis; and
- produce accounts in accordance with applicable law and regulation.

Most loan agreements also specifically deal with a significant accounting change, such as the introduction of FRS102 (but some of them don't).

Typically, those agreements which cater for an accounting change will provide for a period of negotiation during which the parties should try to agree new covenants which are consistent with the new accounting regime but also reflect the existing commercial deal as closely as possible.

However, what happens if agreement is not reached? Loan agreements typically provide for a number of options:

- Binding expert determination, possibly (but not always) by the borrower's auditors.
- Lender's discretion to set new covenants. Hopefully the wording will say that in setting these covenants the lenders have to reflect the existing agreed commercial deal as closely as possible and/or that they have to act reasonably. However, this is not always the case.
- Auditor's certificate – in this certificate, the borrower's auditors would set out an explanation and supporting calculations showing how to work back from covenant numbers extracted from accounts produced on the "new" basis to the corresponding covenant numbers that would have been extracted if the accounts were produced on the "old" basis.
- Accounts to be produced on two bases – the borrower would have to continue to produce

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accounts on the "old" basis for the sole purpose of evidencing covenant compliance in addition to having to produce accounts on the "new" basis for statutory purposes (often this is expressed to be an alternative to the auditor's certificate mentioned above).

Those agreements that are silent on the consequences of accounting change are still likely to contain an obligation on the borrower to produce financial information on a consistent basis. In order to comply with this consistency obligation, borrowers would still need to report to lenders on the "old" basis, so this position looks similar to scenario 4 (accounts to be produced on two bases).

Source: Fotolia

So what should housing associations be doing to prepare for the introduction of FRS 102?

First, RPs should be reviewing all of their current loan agreements, to check for obligations relating to consistency of reporting and provisions setting out how to deal with accounting change.

They should then be considering how best to demonstrate continued compliance with their existing financial covenants. For example, we would advise RPs to consult with their auditors at an early stage to see whether they would be prepared to give the auditor's certificate mentioned above or perhaps act as experts to suggest updated covenants. They may also want to consider the potential costs and practicalities of continuing to run a parallel accounts system for the sole purpose of evidencing covenant compliance.

However, we expect that in many cases these solutions are likely to be no more than short term "fixes", which may well turn out to be cumbersome and expensive and only suitable for a limited period.

We anticipate that the only long-term solution that will work for both parties is to discuss with your lenders appropriate financial covenants which most closely reflect the current loan agreement position.

You will need to start work on proposals to put forward to your lenders and how you can best demonstrate that they are equivalent to your existing covenants.

What else you might want to do while you are there

As you will be focusing on your current covenant definitions and most likely discussing them with your lenders, why not take the opportunity to tidy them up?

For example, we have seen some loan agreements that refer to GAAP and/or SORP as at a particular time as a reference point for calculation of financial covenants. If this reference is now historic, you may be preparing financial covenants on the basis of the current accounting position whereas the loan agreement requires you to do something else. We have been involved in a number of disputes between borrowers and their lenders on this very point.

Are you existing covenant definitions fit for purpose? We suspect that in many cases financial covenant definitions do not reflect what the parties think they have agreed or actually do in practice. Do not assume that because you have been reporting against covenants which are slightly different from the definitions in your loan agreement that the lender will continue to accept this approach or that legally the loan agreement has been amended.

Conclusion

There has been much talk of lenders using the introduction of FRS102 as an excuse to re-price existing loans.

However, bearing in mind the purpose of financial covenants, we believe that it would be difficult both commercially and legally for lenders to seek to re-price an RP on the basis of accounting change alone.

The challenge for RPs is to work out how best to be able to demonstrate continued covenant compliance.

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