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Financial statement provisions in term-loan agreements

National Conference of Bankers and Certified Public Accountants

American Bankers Association. Credit Policy Committee

American Institute of Certified Public Accountants. Committee on Relations With Bankers and Other Credit Executives

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Financial Statement Provisions in Term-Loan Agreements
A Statement Prepared
by the
National Conference of Bankers and Certified Public Accountants

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and
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American Institute of Certified Public Accountants

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Any provisions of term-loan agreements set forth in this booklet are not to be considered as recommended forms but rather as suggestions that should be used only in consultation with and upon the advice of bank's counsel.
This is the second publication of the National Conference of Bankers and Certified Public Accountants (Section II on Financial Reporting of Borrowers). The first, The Auditor's Report—Its Meaning and Significance, was issued in July 1967.

Formed in 1966, Section II of the Conference is composed of designated representatives of The American Bankers Association and the American Institute of Certified Public Accountants. By mutual consent these two groups invited representatives of Robert Morris Associates, the national association of bank loan officers and credit men, to participate in the discussions.

The purpose of this section of the Conference is to seek through continuing dialogues, and to disseminate among all bankers and certified public accountants, a better understanding of the role of each and of the function of each in serving together to meet more effectively the financing and financial reporting needs of American business enterprises.

One area of mutual concern in the past has been the wording of financial statement provisions in term-loan agreements. Banks and other lending institutions have not infrequently used covenants in this area that, to some extent, may have been inadequate, difficult to interpret, or impractical of compliance by the independent auditor.

Following extended discussions of the problems and needs of the lender, the borrower, and the auditor, the bankers and certified public accountants of the Conference have agreed unanimously on the substance of this publication and offer it in the hope that it may prove of material aid to all concerned with the problem of adequate, understandable, and practical financial reporting requirements in term-loan agreements.
NATIONAL CONFERENCE OF BANKERS AND CERTIFIED PUBLIC ACCOUNTANTS

Section II on Financial Reporting of Borrowers

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INTRODUCTION

The members of the Section on Financial Reporting of Borrowers of the National Conference of Bankers and Certified Public Accountants made a study of a number of term-loan agreements. We found that there is a great disparity in the language used in describing seemingly similar covenants and conditions relating to financial statements and accounting matters and that this disparity has caused considerable confusion in the interpretation of the agreements. Our members have concluded that a "point outline" of certain items to be considered in drafting term-loan agreements and some suggestions for common language dealing with certain of the more common covenants found in such agreements would be useful to all concerned, that is, lenders, borrowers, and independent auditors. We also felt it was desirable to include some easily understood definitions for accounting terminology found in the agreements. With these objectives in mind, we have prepared the following report.

The first section contains the "point outline" of items which should normally be considered in preparing the term-loan agreement, and examples of a variety of matters pertaining to the financial, accounting, and reporting stipulations usually found in term-loan agreement covenants. The second section sets forth suggested wording for inclusion in term-loan agreement requirements and stipula-
tions that deal with audited or unaudited financial statements and accounting terminology, namely:

I. Borrower's Warranty Regarding Financial Statements
II. Financial Statement Convenants
III. Discussion of Financial Statements and Financial Affairs with Auditors and the Use of Audit Reports
IV. Accounting Terminology

The suggested wording attempts to draw on the thoughts expressed under most of the provisions in the “point outline.”

We do not suggest that all the matters mentioned should necessarily appear as covenants in any given agreement since, obviously, each situation must be governed by the circumstances existing at the time the loan is negotiated. If, however, the conditions are such as to indicate that any one or more of the items mentioned in the “point outline” should be included, we believe the “suggested wording” contained in the second section of this paper will be helpful in clarifying the intended meaning of the covenants so as to eliminate confusion in interpretation of the agreement.
The outline is an expansion of the ideas and concepts contained in each of the following points concerning financial statements and financial information of the borrower (the "Company") as they relate to covenants under a term-loan agreement (the "Agreement"):  

I. Frequency and Timing of Financial Statements  
II. Nature of Statements  
III. Submission of Reports to the Lending Institution (the "Bank") by Management  
IV. Relationships with Independent Certified Public Accountants (the "Auditor" or the "Auditors")  
V. Application of Generally Accepted Accounting Principles  
VI. Compliance Reports  
VII. Financial Forecasts  
VIII. Control of Other Types of Financing  
IX. Accounting Terminology  

I. Frequency and Timing of Financial Statements  
   A. At the time of the loan the Bank may request:  
      1. Audited financial statements for the latest year or the last three to five years.  
      2. Unaudited financial statements for the interim period (at least the latest available quarterly statement) from date of the latest available audited statements.  
      3. Cash forecast for each year of the proposed term of the loan.  
   B. Subsequent to the loan the Bank may request:  
      1. Unaudited periodic financial statements (monthly or quarterly) to be submitted within 45 to 60 days following the period covered, accompanied by the report thereon of an authorized financial officer of the Company.  
      2. Audited financial statements for each fiscal year to be submitted within 90 to 120 days after year-end
accompanied by a report with an opinion, unqualified as to scope limitations imposed by the Company, of an Auditor selected by the Company and acceptable to the Bank.

II. Nature of Statements

A. Types of statements that might be requested by the Bank:

1. Basic financial statements (balance sheet and statements of income and retained earnings).

2. Statement of source and application of funds or of changes in working capital.

3. Details of consolidation—
   a. Subsidiaries included in consolidation.
   b. Subsidiaries not included in consolidation shown as a combined group—foreign subsidiaries might be a separate group.

4. Financial statements of the Company only, or various combinations on a consolidated or consolidating basis, depending upon whether the Agreement is with the parent or a subsidiary and whether or not the parent has guaranteed the loan.

5. Financial statements of 50 per cent owned entities, joint ventures, and companies in which a material investment or creditor position is held.

6. Supplementary information (usually not referred to specifically), for example—
   a. Details of cost of goods sold and selling, general, and administrative expenses.
   b. Summaries of aged accounts receivable and collections thereon.
   c. Details of property, plant, and equipment accounts.
   d. Other data or statements that might be pertinent or normally generated.

B. Required interim reports from the Company might include:

1. Basic financial statements.

2. Such supplementary data and consolidating or consolidated data as agreed to.
3. Copies of periodic reports issued to shareholders by the Company.
4. When requested, comparison of actual results with budget projections.

C. Required annual reports from the Company might include:
   1. Basic financial statements, possibly including a statement of changes in working capital.
   2. Basic statements for such consolidated or nonconsolidated subsidiaries as might be pertinent under the circumstances.
   3. Those supplementary schedules normally presented as supplementary information on an annual basis.

III. Submission of Reports to the Bank by Management

   A. Copies of all opinion reports by the Auditor on audited financial statements.
   B. Annual and periodic reports to the Securities and Exchange Commission (SEC) as well as proxy statements and registration statements.
   C. Reports from the Auditor relating to compliance with and observance of the covenants under the Agreement, if requested.
   D. Listing applications with stock exchanges.

IV. Relationships with Auditors

   A. The Agreement may give the Bank and the Auditor authority to discuss financial statements and financial affairs, including so-called "management letters," of the Company, but only in the Company's presence or with its consent.

   Ordinarily, the Auditor would prefer to have the Company present to avoid any possible misunderstanding of the substance of the discussion between Bank and Auditor, but there may be an instance where the Company would be willing to permit such discussions without its presence.

   B. Authority may also be given in the Agreement to the Bank (which the Bank should exercise only with the approval of its counsel) to submit any of the Company's
audit reports to the Practice Review Committee of the American Institute of Certified Public Accountants (AICPA) or of a state society of certified public accountants.

C. Written communications from the Auditor concerning any matters relating to the Agreement should be directed to the Company for transmission to the Bank at the Company's discretion or in accordance with any agreement it may have with the Bank.

V. Application of Generally Accepted Accounting Principles

A. All covenants should be based on the "application of generally accepted accounting principles employed by the Company as of the date of this Agreement."

1. This requires that generally accepted accounting principles be employed by the Company at the time of the Agreement or that the effect of any departures from such principles be recognized in establishing covenants.

2. The Agreement may provide, however, that prescribed ratios or other requirements under various covenants of the Agreement may be amended appropriately at the request of the Company and at the option of the Bank should there be any subsequent change in the application of accounting principles when the change has the approval of the Auditor and when the Bank has been notified in writing of any such change in any period under report and the effect of such change as compared with the preceding period.

VI. Compliance Reports

A. It should be understood that the Auditor has a responsibility to see that the financial statements contain adequate disclosures of any defaults under the Agreement, relating to accounting matters, which came to his attention during the course of his examination and which continue to exist at the date of the balance sheet or at the date of his report, unless the defaults have been waived. Additionally, where such waiver has not been obtained by the Company, the Auditor may be required to qualify his opinion, disclaim an opinion, or in some
cases, render an adverse opinion, depending upon the circumstances and upon the possible effect of the default on the financial statements.

B. The Agreement may provide that the Company will submit to the Bank periodic written reports relating to the matter of compliance with specific covenants, accompanied where appropriate by statements or schedules that can be measured against the financial statements to demonstrate that the Company has complied with those covenants.

C. The Agreement may also provide that the Auditor will, at the request of the Bank, report on the Company’s compliance with various covenants relating to accounting matters.

1. The Agreement may specify that the Auditor will provide a separate letter stating whether during the course of his examination he obtained knowledge of any default relating to accounting matters (whether or not waived) under the terms of the Agreement.

2. The Agreement may also require that the Auditor's compliance letter specifically cover certain aspects of the financial statements in relation to the requirements under covenants covering such matters as consolidated working capital, dividend restrictions, limitations on capital expenditures, and other such specified covenants.

In those instances in which the Auditor is required to report on compliance, such requirement should be set forth clearly in the Agreement. Also, the pertinent covenants, to the extent practicable, should be stated simply and be capable of measurement. The Agreement should not impose any responsibility on the Auditor that is incompatible with his professional competence. The Auditor’s objective in the ordinary examination of financial statements is the expression of an opinion on the fairness with which the financial statements, taken as a whole, present the financial position and results of operation and not as to the exactitude of specific accounts. Even when specific auditing procedures are employed for the purpose of determining loan compliance, the Auditor may find he is not able to express an unqualified opinion since
there may be ramifications as to technical defaults, particularly relating to matters of legal interpretation, the evaluation of which is outside the area of the Auditor's professional competence. It is desirable, therefore, that the Auditor be consulted during the negotiating of the Agreement to determine (i) that the requirements to be imposed upon the Auditor are within the area of his professional competence, (ii) that the specific audit procedures required to determine compliance are practicable, and (iii) the wording to be included in the Agreement with respect to the language to be contained in any compliance report.

VII. Financial Forecasts

A. The Bank should be aware of Rule 2.04 of the AICPA Code of Professional Ethics and Opinion No. 10 relating thereto.

B. Forecasts are often required when the loan is being negotiated. If the Bank requires the Auditor to become involved, it should be understood that the Auditor will not be able to express an opinion on the forecast. In addition, he will ordinarily restrict his report to parties he designates therein, and will not permit his name to be referred to in connection with forecasts in lending or financing agreements or similar documents.

C. Financial forecasts might be required from the Company on a periodic or annual basis.

In any event, the financial forecasts, including cash flow and balance sheet projections, should be supported by an itemized list of assumptions upon which the forecasts were based in sufficient detail to permit the Bank to appraise their validity.

VIII. Control of Other Types of Financing

A. Typical examples of other types of financing, sometimes referred to as "off-balance-sheet" financing, some of which are now required under opinions of the Accounting Principles Board of the AICPA to be recognized in the financial statements, are:

1. Lease agreements covering the right to use property in exchange for rental payments where the terms
of the lease do not result in the creation of a material equity in the property under Opinion No. 5 of the Accounting Principles Board of the AICPA and hence do not require that the property and the related obligation be included as an asset and liability in the balance sheet of the Company.

2. Phantom subsidiaries created in connection with lease arrangements in order to avoid the requirement of capitalizing a lease purchase agreement.

3. Arrangements whereby unconsolidated subsidiaries, which are often "thinly capitalized," enter into long-term borrowings or leases—
   a. Whose obligations are guaranteed by the Company.
   b. With which the Company has "keep-well" agreements whereby it is committed to see that the subsidiary maintains minimum levels of financial strength and/or minimum levels of earning power.

4. Financing certain phases of the Company's operations through the use of "arm's-length" shell corporations, generally jointly owned affiliates—
   a. Affiliated company amortizes loan obligations from the proceeds derived from selling all its output to the joint owners.
   b. Affiliated contractors.

5. Sales of current assets—
   a. Sales or discounts of receivables with recourse.
   b. Sales of receivables on a "nonrecourse" basis if there are repurchase options or material reserve requirements.
   c. Sales of inventory (such as automobiles) with repurchase commitments.

6. Vendor financing (Sears Plan, et cetera) wherein major national retailing chains obtain financing for their independent suppliers. This financing uses a letter of commitment to the Bank, stating that the chain will take the goods out of the field warehouse on agreed-upon dates and remit to the Bank at contract prices.
7. Repurchase agreements covering products sold to and financed by others.

8. Any other guarantees, endorsements, repurchase commitments, or other legal devices to effect the same general purpose that could have an adverse effect on the financial position of the Company.

B. Control of off-balance-sheet financing can be achieved in terms of the Agreement by:

1. Making the covenants applicable to the financial position or results of operations on a basis that consolidates the accounts of the parent and all its subsidiaries.

2. Adjusting the statements of the Company on a pro forma basis for covenant compliance purposes by—
   a. Capitalizing leases covering the lesser of (i) the useful life of the asset or (ii) periods of three years or more from the date of inception, at appropriate rates.
   b. Restoring to the balance sheet, in contra accounts, the dollar amount of current assets sold, remaining subject to recourse, as current assets and current liabilities.
   c. Consolidating (pro forma) the nonconsolidated "keep-well" and/or "arm's-length" affiliated companies with the financial statements of the Company.
   d. Considering commitments under guarantees, et cetera, to be debt.

3. The Company could be required to keep the Bank informed as to the amounts and particulars relating to guarantees, endorsements, and similar commitments.

IX. Accounting Terminology

The Agreement should anticipate the need to define certain accounting terms:

A. The term "prepared in accordance with generally accepted accounting principles" should be used when referring to financial statement requirements.

B. The Agreement should include a section for "definition of terms" covering the more important accounting terms used in the Agreement.
Parenthetical, italicized references are made for the insertion of words relating to consolidated statements for those instances in which the Company has consolidated subsidiaries or to other variations to fit the circumstances.

I. Borrower's Warranty Regarding Financial Statements

The (consolidated) balance sheet of the Company (and its subsidiaries) as of December 31, 19x6 and related statements of (consolidated) income and retained earnings for the year then ended, accompanied by the report thereon of __________, independent certified public accountants, and the unaudited (consolidated) balance sheet of the Company (and its subsidiaries) as of March 31, 19x7, and related statements of (consolidated) income and retained earnings for the three months then ended, accompanied by the report thereon of an authorized officer of the Company, all of which have been delivered to the Bank by the Company, present fairly the (consolidated) financial position of the Company (and its subsidiaries) as of the respective dates and the results of its (consolidated) operations for the periods indicated, in conformity with generally accepted accounting principles applied on a consistent basis.

Statement should recite any qualified, disclaimed, or adverse opinion contained in the reports of the Auditor or of an authorized officer of the Company.

II. Financial Statement Covenants

A. The Company shall deliver to the Bank within 45 days (or other designated period) after the close of each of the first three quarters of each fiscal year of the Company, beginning with the quarter to end on June 30, 19x7:

1. A (consolidated) balance sheet of the Company as of the close of each quarter and statements of (consolidated) income and retained earnings for that portion of the fiscal year-to-date then ended, prepared in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding period or containing disclosure of the effect on the financial position or results of operations of any change in the application
of generally accepted accounting principles during the period, and reported on by an authorized financial officer of the Company;

2. A written statement by an authorized financial officer of the Company at the end of each quarterly period, including the last quarter of each fiscal year, that there existed no condition or event which constitutes a default in the observance, performance, and fulfillment of any of the covenants, agreements, or conditions contained in this Agreement or in the Notes, or which, after notice by the Bank, or lapse of time, or both, would constitute such default, or a statement specifying the nature and period of existence of any such condition or event; and

3. The following schedules at the end of each quarter, including the last quarter of each fiscal year, reported on by an authorized financial officer of the Company:

These may be schedules of supplementary financial information or schedules demonstrating compliance with certain covenants contained in the Agreement such as the maintenance of working capital, limitations on dividend payments, incurrence of indebtedness, capital additions, lease obligations, et cetera.

B. The Company shall deliver to the Bank within 90 days (or other designated period) after the close of each fiscal year of the Company, beginning with the year to end on December 31, 19x7:

1. A (consolidated) balance sheet of the Company as of the close of such fiscal year and statements of (consolidated) income and retained earnings and source and application of funds for the year then ended, prepared in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year or containing disclosure of the effect on financial position or results of operations of any change in the application of accounting principles during the year, and accompanied by a report thereon, containing an opinion, unqualified as to scope limitations imposed by the Company, of a firm of independent certified public accountants selected by the Company and acceptable to the Bank.
The Bank should insist that the Company make every effort to obtain an unqualified opinion from the Auditor. For a variety of reasons, the Auditor may sometimes be unable to render an unqualified opinion. As a minimum, however, the Bank should insist upon an opinion that has not been qualified because of scope limitations imposed by the Company.

2. A statement from the independent certified public accountants that, in making their examination of the (consolidated) financial statements of the Company, they obtained no knowledge of any event of default by the Company in the fulfillment of any of the terms, covenants, provisions, or conditions of Sections (here insert Section numbers) of the Agreement insofar as they pertain to accounting matters relating to this Agreement or to the Notes, or which, after notice by the Bank, or lapse of time, or both, would constitute such a default; or a statement specifying the nature and period of existence of any such condition or event disclosed by their examination.

C. The Company shall deliver to the Bank within 10 days (or other designated period) upon the Company’s issuance or receipt thereof, copies of:

1. All reports submitted to the Company by its independent certified public accountants that contain an opinion rendered in connection with an examination of any financial statements of the Company by such accountants; the preliminary prospectus and the effective prospectus contained in any registration statements filed with the Securities and Exchange Commission; any annual or periodic reports filed with such Commission; and any listing application filed with any stock exchange.

2. Each annual report and all other reports, including proxy solicitations, which the Company shall from time to time send to its shareholders.

D. Upon the Bank’s written request, the Company shall deliver to the Bank promptly such other information about the financial condition and operations of the Company (and its subsidiaries) as the Bank may, from time to time, reasonably request.
E. The determination of the Company's compliance with all covenants relating to accounting matters contained in this Agreement or the Notes shall be based on the application of generally accepted accounting principles employed by the Company as of the date of this Agreement unless otherwise subsequently and specifically agreed to in writing by the Bank. This covenant in no way restricts the Company from making changes in the application of such accounting principles for purposes other than determination of compliance with such covenants, provided such changes have the approval of the Company's independent certified public accountants and provided the Bank is notified, in writing, of any such change in any period under report and the effect of such change, as compared with the preceding period. Any covenant in this Agreement or in the Notes involving any account that is affected, directly or indirectly, by any such change in the application of accounting principles may, at the request of the Company and at the option of the Bank, be modified in recognition of the effect of such change.

III. Discussion of Financial Statements and Financial Affairs with Auditors and the Use of Audit Reports

The Company hereby authorizes and grants to the Bank, upon its request, the privilege of (i) discussing the Company's financial statements and its financial affairs at any time and from time to time with the Company's independent certified public accountants, and hereby further authorizes and requests any representative of such accountants to participate in any such discussions requested by the Bank, provided, however, that any such discussion shall be conducted only in the presence of an officer of the Company or with the consent of the Company; and (ii) submitting any of the Company's audit reports to the Practice Review Committee of the American Institute of Certified Public Accountants or of a state society of certified public accountants.

IV. Accounting Terminology

The following list of definitions covers accounting terms frequently found in term-loan agreements. The definitions are not meant to be standard or complete definitions to be used in all circumstances, but are presented as guides in arriving at more precise wording in term-loan agreements so as to avoid inappropriate or improper definitions of
accounting terms. It is suggested that Bank counsel be consulted in drafting precise language to fit the particular circumstances.

As used in this agreement:

A. "Generally accepted accounting principles" shall mean those principles set forth in Opinions of the Accounting Principles Board of the American Institute of Certified Public Accountants or which have other substantial authoritative support and are applicable in the circumstances as of the date of the report.

B. "Consistent basis" shall mean, in reference to the application of generally accepted accounting principles, that the accounting principles observed in the current period are comparable in all material respects to those applied in the preceding period.

C. "(Consolidated) working capital" shall mean the excess of current assets over current liabilities, both as shown on the Company's (consolidated) balance sheet as of the date of determination, all determined and prepared in accordance with generally accepted accounting principles.

D. "(Consolidated) capital additions" shall mean the aggregate of all the expenditures or costs incurred by the Company (and its subsidiaries) for the acquisition and ownership of land, buildings, machinery, equipment, furniture, fixtures, and all other tangible fixed assets, and for leasehold improvements or the rights to the use of such properties under capitalized lease obligations, during any fiscal year or other designated period.

E. "(Consolidated) long-term indebtedness" shall mean any and all bonds, debentures, capitalized leases, notes, or other debt, whether secured or unsecured, which shall be payable after twelve (12) months from the balance sheet date at which the determination is made, as shown by the Company's (consolidated) financial statements, all determined and prepared in accordance with generally accepted accounting principles.

F. "(Consolidated) total liabilities" shall mean the sum of the current liabilities and long-term debt (and any other designated accounts) as shown on the Company's (consolidated) balance sheet as of the date of determination, all determined and prepared in accordance with generally accepted accounting principles.
The following definitions would be added only when consolidated financial statements are applicable.

G. "Subsidiary" shall mean any corporation of which the Company owns directly or indirectly more than fifty percent (50%) of the outstanding voting shares of the corporation at the time of determination.

H. "Consolidated subsidiary" shall mean any subsidiary included in the Company's financial statements consolidated in accordance with generally accepted accounting principles.

I. "Consolidated net income" shall mean the net income (or loss) of the Company and its consolidated subsidiaries for any period or fiscal year, determined in accordance with generally accepted accounting principles.