Feature

KEY POINTS
- External market pressures in recent years have created potential financial underperformance issues for some borrowers in the European mid-market.
- The approach for the accounting treatment is typically agreed upfront and documented, yet complicated financial calculations can leave private credit lenders concerned as to whether the correct accounting treatment is being consistently applied by the borrower.
- Compliance with financial covenants may be questioned in certain circumstances.
- Loan documentation should provide various protections and rights for the lenders to request additional information where there appears to be discrepancies.
- The lender may also be able to amend the loan agreement in exchange for a waiver.

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Dodgy financial reporting or financial covenant breach

In this article we consider how preservation of an agreed approach to financial monitoring and calculations for leveraged finance loans in the European mid-market is fundamental to maintain suitable protections for private credit lenders. Discrepancies in figures can raise red flags as to whether the financial reporting is simply inconsistent or whether the sponsor is attempting to hide a financial covenant breach. We discuss options available to lenders to clarify figures and request additional information.

In recent years, we have observed a marked increase in Events of Default (EoDs) arising from financial underperformance in the European mid-market. This trend is largely attributable to the prevailing high interest rate and inflationary environment, with borrowers facing escalating debt service costs and compressed revenue margins.

Against this backdrop, we have also seen borrowers and sponsors seeking to maximise the use of add-backs in loan agreements to inflate EBITDA figures and thereby maintain covenant compliance. Private credit funds are increasingly questioning or disputing the quarterly and monthly financials provided by borrowers. Such disputes occur less frequently with annual financial statements, as these are audited and therefore less susceptible to manipulation. The disagreements typically centre on whether the borrower has in fact satisfied its quarterly financial covenant maintenance test(s).

While it is understandable that borrowers and sponsors seek to maximise add-backs and similar adjustments to ensure compliance with financial covenants, financial reporting should remain consistent with the accounting principles and practices agreed at the time of underwriting (the "Agreed Accounting Rules").

Preserving this consistency with the Agreed Accounting Rules is essential to maintain the commercial intent between the parties in relation to the transaction.

Where suspicions or disputes arise as to whether borrower prepared financials deviate from the Agreed Accounting Rules, potentially enhancing reported figures, lenders have various options available to investigate. In such circumstances, financial reporting issues go beyond technical discrepancies and may point to a broader strategy of presenting a more favourable financial position than is the factual reality.

TYPICAL AGREED ACCOUNTING RULES

The Agreed Accounting Rules construct is designed to ensure that financial reporting remains consistent, transparent and fair throughout the term of the loan, thereby protecting the interests of both lenders and borrowers. Put simply, it ensures "apples are compared with apples" when testing financial covenants against reported financials, and guards against "opportunistic" accounting methods that artificially inflate figures.

The Agreed Accounting Rules are typically documented as follows:

(a) **Consistency with base case model and original financial statements:** The borrower is required to prepare its financial statements using the same accounting principles, practices, and financial periods as those used in the base case model (ie the financial model agreed at the outset of the deal and used to set covenant levels) and the original financial statements. On rare occasions, the accounting reference base may even include buy-side financial due diligence reports. Minor differences due to customary year-end adjustments are permitted. The requirement to maintain consistency in reporting is standard across nearly all mid-market deals, although we are seeing some pushback in the upper mid-market.

(b) **Notification of changes**

  (i) If the borrower changes its accounting principles or practices, it must notify the agent (the lenders' representative) and provide:

    (a) a description of the adjustments required for the financial statements to reflect the accounting basis of the original base case model or the original financial statements (as applicable); and

    (b) sufficient information to enable the agent and lenders to assess compliance with financial covenants, determine the applicable margin, calculate prepayments from excess cash flow (where relevant), and compare the new financial position to the base case model or original financial statements.

(ii) This notification obligation is standard across nearly all mid-market deals, though we are increasingly seeing pushback in the upper mid-market.

(c) **Negotiation**: If there is a change in accounting principles or practices, the parent and the agent (acting on behalf of the majority lenders) must negotiate in good faith (typically within 30 days of the notification) to determine whether the change "materially alters the commercial effect of the agreement". If it does, the parties are required to agree amendments that preserve the original commercial intent or otherwise provide lenders with protections comparable to those contemplated at signing. Certain loan agreements further provide that, if the parties cannot agree on the required amendments, the matter is referred to an internationally recognised firm of accountants for a binding determination.

OPTIONS OUTSIDE THE AGREED ACCOUNTING RULES

Where the Agreed Accounting Rules framework described above does not achieve the desired outcome for lenders – for example, where the borrower does not consider there to have been a change in principles or practices, or where lenders wish to adopt additional approaches alongside that framework, a number of potential documentary protections are available:

(a) Information miscellaneous

Loan agreements typically include a clause titled "Information: miscellaneous", which gives lenders (through the agent) the right to request "further information regarding the financial condition, assets and operations of the Group (including any requested amplification or explanation of any item in the financial statements, budgets or other material provided by any Obligor)". This undertaking is useful because it allows lenders to seek clarifications to assess any discrepancies in the financials. Where a clear error is identified, lenders and the borrower should ideally be able to resolve the issue through good faith negotiation. However, if the figures remain disputed, this right unfortunately does not, in itself, provide a mechanism for resolution.

(b) Continuing EoD?

(i) Most mid-market loan agreements include an access right. This is usually triggered following the occurrence of an EoD – in some deals it applies to any EoD, while in others it is limited to material EoDs. At the more lender friendly end, the right can also be exercised where the agent "reasonably suspects" an EoD is continuing or "is reasonably likely to occur". The right gives the lenders, the agent, the security agent and their professional advisers: (a) free access to the premises, books, accounts and records of each member of the group; and (b) the ability to meet with senior management to discuss the EoD and the steps being taken to remedy it. This right is intrusive and rarely exercised. When it is used, it tends to be in situations where the relationship between the lenders, the borrower and the sponsor has already deteriorated. Typical scenarios include concerns that covenant miscalculations have persisted across several reporting periods, a lack of timely engagement by the borrower or sponsor in addressing lenders' questions, weaknesses in reporting quality (such as the absence of supporting calculations), or situations where auditors have declined to sign off on the annual financial statements. In practice, this contractual right operates more as an incentive to encourage compliance than as a tool lenders actually deploy.

(ii) Where an EoD is continuing, borrowers are typically incentivised to co-operate to avoid the risk of enforcement proceedings, and lenders can use the waiver process as a point of leverage to secure additional protections or clarifications that might not otherwise have been achievable at signing. Lenders may, as a condition to granting a waiver, require:

(a) amendments to the loan agreement to reflect the change in accounting principles or practices so as to preserve the original commercial intent or otherwise provide lenders with protections comparable to those contemplated at signing;

(b) resubmission of compliance certificates previously delivered based on revised financial figures. This allows them to test whether suspicions about overstated figures are correct; and/or

(c) replacement of certain members of the management team, in particular the chief financial officer. This is an extreme measure and is rarely invoked, but it can be justified where lenders have lost confidence in the accuracy or integrity of the borrower's financial reporting. The chief financial officer is often in the spotlight, given their central role in preparing and certifying financial information and compliance certificates. In these circumstances, lenders may require that a replacement with appropriate experience and credibility be appointed, sometimes with lender input or approval rights.

(c) Annual financial statements

Where the lenders and the borrower continue to dispute the financials and the basis upon which they have been prepared, reliance can ultimately be placed on the audited annual financial statements. These statements, prepared in accordance with established accounting standards and verified by an independent auditor, should provide a definitive reference point against which the accuracy of the monthly and quarterly figures can be assessed. While they are not a perfect solution, given they are only produced annually and are provided several months after each financial year, they can

Biog box

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serve as a reliable benchmark for resolving disputes as to the integrity of the borrower's interim reporting.

INCORRECT FIGURES

If, through one of the options outlined above, it becomes apparent that the reported EBITDA figures have been overstated, lenders may require the previously delivered compliance certificates to be resubmitted based on the correct figures. Where those revised certificates indicate covenant breaches, lenders may then decide whether to grant waivers of the breaches at that time. The rationale for this exercise is twofold:

(i) to confirm that the borrower's financials are being reported in accordance with the basis agreed at signing, thereby preserving the commercial intent of the deal; and

(ii) to provide lenders with additional bargaining power where covenant breaches are identified, enabling them to negotiate amendments, enhanced reporting undertakings, and/or other protections in exchange for granting waivers.

CONCLUSION

In an ideal world, concerns would be resolved through good faith discussion between the contracting parties. Where that is not possible, loan agreements provide lenders with a range of tools to test and, where necessary, challenge reported numbers. Used prudently, these protections help ensure that financial reporting remains consistent with the agreed position at signing and that the commercial balance of the deal is preserved. ■

Further Reading:

- The evolving fiction of EBITDA in the European leveraged finance loans market (2018) 10 JIBFL 603.
- "High water" mark EBITDA provisions: should lenders fight fires with a pre-agreed "low water" mark EBITDA de minimis? (2025) 5 JIBFL 300.
- Lexis+® UK: LexisPSL Banking & Finance Practical Guidance: Practice Note: Introductory guide to financial covenant.