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New Accounting Standards Can Significantly Impact Credit Agreements

By Kim Desmarais

New accounting standards for leases can have unintended consequences on debt covenants and financial ratios in credit agreements. Under the new rules (Accounting Standards Codification Topic ("ASC") 842 and International Financial Reporting Standard ("IFRS") 16), nearly all operating leases, in addition to finance leases (formerly, capital leases), are required to be recognized as a liability on the balance sheet of a lessee if the lease term is greater than twelve months.

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Under old operating lease rules, an operating lease was neither an asset nor a liability on the balance sheet and could be reported in the footnotes to the financial statements as "off-balance sheet leases." The lease payments were expensed by lessees on a straight-line basis in net income over the term of the lease. Hence, not included in "indebtedness" definitions and not added back to EBITDA. With the new changes, lessees must classify their leases as either operating leases or finance leases and must record on their balance sheet nearly all leases with terms greater than twelve months as right-of-use assets and as lease liabilities. Under ASC 842, lease payments under operating leases will continue to be expensed on a straight-line basis over the term of the lease, while payments under finance leases will continue to be recognized as both amortization expense and interest expense. Under IFRS 16, lease payments under both operating leases and finance leases will be recognized as amortization expenses and interest expense. While ASC 842 has created a new "operating liability" for operating leases to distinguish between finance leases that are treated as debt, IFRS 16 does not include this distinction. Thus, operating leases may now constitute "indebtedness" and the lease payments may be added back to EBITDA, both of which could have a negative impact on debt covenants and financial ratios in lessees' financing agreements.

To avoid inadvertently being in default under these new rules, companies will have to pay close attention to contractual covenants and related definitions in their existing and new debt financing arrangements. The new rules will cause companies to re-evaluate "net worth" based concepts as they will have less consolidated net worth after including operating leases as liabilities. The new accounting treatment could also affect permitted debt. Now that most operating leases will be brought on balance sheet, debt incurrence and leverage-based covenants will need to be reviewed to analyze the potential impact. The changes can also affect financial definitions including, for example, capital leases used in fixed charge or interest coverage covenants. The tables below set forth financing agreement provisions that could be affected by the new accounting rules and different approaches companies may take to deal with these changes.

AFFECTED CREDIT AGREEMENT PROVISIONS

Accounting Terms	Financial Definitions	Financial Covenants (If Any)	Negative Covenants
• Accounting Terms • Definition of GAAP • Changes to GAAP	• "Capital Lease" definition • "Indebtedness" definition • "Net Worth" based concepts	• Fixed charge or interest coverage covenants need to be adjusted • Leverage based covenants need to be adjusted	• Permitted Debt • Permitted Liens

CREDIT AGREEMENT APPROACHES

Freeze GAAP	Grandfather Leases	Adopt New GAAP	Agree to Agree
• Freeze GAAP at closing • Ignore any changes • Requires reconciled financial statements	• Recognize GAAP changes, but treat existing operating lease the same • New leases follow new GAAP • Requires reconciliation	• Follow new lease rules as adopted • No financial reconciliation • Must comply with all covenants	• Follow changes to GAAP unless Borrower or Required Lenders freeze • Work in good faith on amendment

For public companies, ASC 842 became effective for annual periods beginning after December 15, 2018. Private companies will have to implement ASC 842 for annual periods beginning after December 15, 2019. Additionally, all companies using IFRS are required to adopt IFRS 16 for annual periods beginning on or after January 1, 2019.

The views and opinions set forth herein are the personal views or opinions of the author; they do not necessarily reflect views or opinions of the law firm with which she is associated.

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