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Got Leases? New Accounting Standard Could Trigger Breaches of Bank Covenants

The future is finally certain for lease accounting. After almost a decade of discussions, the Financial Accounting Standards Board released Accounting Standards Update No. 2016-02, *Leases* (Topic 842) (the "ASU") on February 25, 2016.[1] The ASU impacts any company that leases assets, as it requires operating leases be placed onto the balance sheets of lessees. Borrowers need to be aware that this mere accounting change could cause a violation of a loan document covenant—without any change in the company's financial condition.

Shifting Operating Leases to the Balance Sheet

GAAP currently categorizes leases as either "capital leases" or "operating leases."[2] Under current GAAP, capital leases are reflected on the lessee's balance sheet, whereas operating leases are not. However, the ASU requires that nearly every lease—other than short term leases (that is, leases with terms of one year or less)—be recognized on a lessee's balance sheet as a right-of-use asset and a lease liability in an amount equal to the present value of the lease payments. In other words, operating leases will no longer be "off-balance sheet." Therefore, the lessee's recorded assets and liabilities will be greater than under today's lease accounting. The effect will be huge: the Equipment Leasing & Finance Foundation estimated in 2011 that this change will add up to $2 trillion in debt to the balance sheets of U.S. companies.

Public companies will be required to comply with this standard for fiscal years (and interim periods during those fiscal years) starting after December 15, 2018. For private companies, the new rules apply for fiscal years beginning after December 15, 2019 (and for interim periods during fiscal years starting after December 15, 2020). Early adoption is allowed.

Impact on Credit Facilities

The revised treatment of operating leases will have a significant impact on financial covenant calculations in lending arrangements and other financing transactions. Any calculation or covenant that is tied to GAAP's treatment of leases is impacted.

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For example, consider the defined term "Debt." "Debt" is typically broadly defined in loan documents to include, among other things, all liabilities under GAAP. So capital lease obligations constitute Debt. Operating leases, on the other hand, currently are generally not classified as Debt in loan documents. However, the ASU will shift operating leases into the definition of Debt, thereby increasing the amount of a borrower's Debt. Such an increase will have a ripple effect throughout the credit agreement, because Debt is a building block definition. For example, Debt is used as an input in many financial covenants and ratios. If the lease accounting revisions cause Debt to be increased by a large enough amount, a borrower might trip its financial covenants. Another Debt-related example is the negative covenant generally prohibiting the borrower from having other Debt. Here, an increase in the amount of Debt caused by the new treatment of operating leases could eat up the previously large-enough permitted debt baskets.

As a result of impacts like these, a borrower should get a handle on its universe of leases and discuss with its banks—and not to mention its accountants, lawyers and other advisors—the impact that the ASU will have on the company's financial statements and loan documents.

Documentation Tips

There are a few methods by which a borrower and a lender can address these accounting developments in new credit facilities or in existing documents that are being amended.

One option is to agree to delay the substantive discussion relating to the impact of changes in GAAP, such as the implementation of the new standards. Under this option, the parties agree to negotiate in good faith, at a later date, to amend the documents to preserve the original intent of the existing or initial covenants in light of any future change in GAAP.

Another possibility is to "freeze" GAAP as it presently stands—either in full or just as to the lease accounting rules. Under such "frozen GAAP," a company's operating leases would continue to be governed by GAAP as it presently exists. So operating leases would remain off of the lessee's balance sheet and out of the definition of "Debt," notwithstanding the looming changes. A downside to this approach, from a borrower's perspective, is that the borrower will need to keep two sets of books. One set will be the actual financial statements in accordance with GAAP as in effect from time to time ("floating GAAP"); the second set of

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books, together with a reconciliation statement, will be needed for purposes of loan documents and covenant compliance.

A final alternative is for a borrower and a lender to model and set covenants at levels that will work under the new accounting treatment—and have those levels in effect immediately. However, lenders may balk at this approach entirely or suggest that the covenant levels be bifurcated, with one level applying prior to the effectiveness of the new rules and another level applying after.

Conclusion

No borrower wants a breach of its loan documents—especially one that is triggered by a mere accounting change. Smart borrowers will be proactive in analyzing the impact of the new lease accounting treatment and plan accordingly.

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[1] In addition, the International Accounting Standards Board on January 13, 2016 issued IFRS 16 *Leases*, which contains many requirements similar to the ASU. This alert concerns itself only with the ASU.

[2] Current GAAP provides that a lessee may treat a lease as a capital lease for accounting purposes if the lease satisfies any of the following requirements: (1) the ownership of the leased asset is automatically transferred to the lessee at the end of the lease; (2) the lessee has the right to purchase the asset at the end of the lease at a bargain price; (3) the lease term is at least 75% of the estimated economic life of the asset; or (4) the present value of the minimum lease payments at the start of the lease is at least 90% of the fair value of the asset. If the lease does not satisfy any of these prongs, it is deemed an operating lease.

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