Covenant Violations Ahead: How Borrowers and Banks Can "Account" for Lease Accounting Changes

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By: Jamie Watkins Bruno and Ryan C. Kenrick

For the past several years, there has been a movement within the Financial Accounting Standards Board (the "FASB") to revise the FASB's approach to lease accounting to ensure that assets and liabilities arising under leases are recognized more clearly and consistently in a company's financial statements. This movement culminated in the joint issuance by the FASB and the International Accounting Standards Board (the "IASB") of an "exposure draft" (the "Exposure Draft") attempting to revise FAS 13, the FASB's main statement on leases. Since being issued last fall, the Exposure Draft has caused quite a stir throughout the leasing community. Many fear the new lease accounting rules proposed by the Exposure Draft could create significant disruption under covenants in loan documents that use a Borrower's leverage as a component, especially those testing total liabilities or measuring indebtedness against EBITDA. Over the past several months, the public outcry from the leasing sector (via comment letters and public round tables) has led the FASB and IASB to give the Exposure Draft a second consideration. As this article goes to press, it is still unclear exactly how the Exposure Draft will be revised; what is clear is that change is on the way. As such, the current Exposure Draft still provides us with the clearest vision of what we can expect.

In its current form the Exposure Draft is an attempt to bring clarity and uniformity to lease accounting. As the FAS 13 guidelines stand now, lessees are required to classify their leases as either capital leases or operating leases. A lease is considered a "capital lease" if any one of the following four tests is met: (i) the lease conveys ownership of the asset to the lessee at the end of the lease term, (ii) the lessee has an option to purchase the asset at a bargain price at the end of the lease term, (iii) the term of the lease is 75% or more of the economic life of the asset, or (iv) the present value of the rents is 90% or more of the fair market value of the asset. The major difference is that, unlike capital leases, operating leases do not typically show up on a company's balance sheet. This omission from the balance sheet often makes it difficult for an investor to fully evaluate the financial health of the company. In reality, however, neither the operating lease model nor the capital lease model currently provides those reading financial statements with a complete and faithful representation of the leasing transaction. The Exposure Draft attempts to address this issue, and proposes that lessors and lessees should apply a "right-of-use" model when accounting for their leases. Such a model would do away with the need to distinguish between capital and operating leases and would ensure that the assets and liabilities stemming from a company's leases would be reported more accurately on the company's financial statement.

As indicated above, the major change is the switch to a "right of use" model. Under such a model, the lessee would recognize its right to use the leased asset for the duration of the lease term as an asset on its balance sheet, while at the same time showing a liability reflecting the lease payments. The lessor, conversely, would recognize the lease payments as an asset and, depending on its exposure to the risks or benefits associated with the leased asset, would either: (i) recognize a lease liability while continuing to recognize the leased asset (known as the "performance obligation approach"), or (ii) derecognize its rights in the leased asset but continue to recognize a residual asset representing the lessor's rights to such asset at the termination of the lease (known as the "derecognition approach").[1] If a lessor retains exposure to significant risks or benefits associated with the leased asset, the lessor would continue to recognize such asset and, in addition, recognize a right to receive lease payments and a lease liability. The lessor would be viewed as satisfying the lease liability continuously over the lease term and, therefore, would recognize lease income continuously over the lease term.

The assets and liabilities recognized by lessees and lessors described above would be measured on a basis that:

- Assumes the longest possible lease term that is more likely than not to occur (including options to extend or terminate);
- Uses expected outcome techniques to reflect the lease payments that include contingent rentals, expected payments under term option penalties, and residual value guarantees specified by the lease; and
- Requires updates when changes in circumstances indicate there have been significant changes in assets or liabilities since the last reporting period.

In essence, these lease accounting changes could eliminate the concept of "operating leases," requiring them instead to be reflected on a Borrower's balance sheet just like capital leases. The Borrower's right to use a leased asset will appear as an asset on the balance sheet, and the Borrower's obligation to make rent payments on that leased asset will constitute a liability. Moreover, these changes could affect *all* leased assets used in a Borrower's business, not just real property leases. Financial performance covenants reflected in current loan documentation likely were designed prior to the effectiveness of these changes. Therefore, Banks can expect a wave of covenant violations in their loan portfolios. These accounting changes could have a particularly adverse effect on highly-leveraged retailers, and on other Borrowers for which Banks rely on a leverage covenant to monitor performance.

Currently there is a lot of uncertainty as to exactly how the Exposure Draft will be implemented. For now, the best practice for Banks and Borrowers at risk for covenant breaches triggered by these proposed lease accounting changes would be to begin discussing modification strategies to avoid an actual default scenario. Borrowers may consider requesting the exclusion of capital leases from any "Indebtedness" or "Total Liabilities" definitions to avoid a technical default, but Banks may resist this all-or-nothing approach. Instead, Banks may request evidence from Borrowers, on a proforma basis, illustrating the changes to their balance sheets under the new lease accounting principles and consider implementing a higher test ratio. Stay tuned for updates as we get a better idea of how the FASB intends to implement the Exposure Draft.

For more information about this topic, please contact Jamie Watkins Bruno, 804.420.6922 or , Ryan C. Kenrick, 804.420.6394 or , or any member of the firm's Financial Services & Real Estate Team.

Related People

- Jamie Watkins Bruno – 804.420.6922 – jbruno@williamsmullen.com
- Ryan C. Kenrick – 757.629.0636 – rkenrick@williamsmullen.com

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