New Accounting Rule Overview

Accounting for leases is going to change in 2019 under both GAAP and IFRS. The change may have unwelcome impacts on financial covenants in pre-2019 loan agreements that are still in effect in 2019.

The new lease accounting rules affect both lessors and lessees. The major impact is on the balance sheet of a lessee. When the rules become effective, the balance sheet of a lessee will show an asset and a liability for each lease. The additional assets and liabilities generally will initially be offsetting. The changes to a lessor’s balance sheet are likely to be less dramatic. There will generally be different assets on balance sheets of a lessor but not an immediate change in the amount of net assets.

Among other changes, the new lease accounting rules also:

- Modify the timing and pattern of lease income and lease expense;
- Recharacterize part of each lease payment as interest paid or received; and
- Eliminate the concepts of “capital lease” and “finance lease.”

1 The IASB decided on October 20, 2015 that the new IFRS lease accounting rules will apply to annual accounting periods beginning on or after January 1, 2019. The FASB decided on November 11, 2015 that the new U.S. GAAP lease accounting rules will start to apply in 2019 for public entities and in 2020 for other entities. (Technically, the new rules apply for financial periods beginning after the previous December 15.) Both decisions are still “tentative.”

2 Watson Farley & Williams does not provide accountancy advice in any jurisdiction. The description of the accounting rules contained in this briefing is solely intended to inform the discussion of the impact of the rules on loan agreements and is based only on a review of the relevant “Exposure Drafts” both dated September 13, 2013. The status of the projects and the relevant documents are available on the FASB website at http://www.fasb.org/sp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123 and on the IASB website at http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Pages/Leases.aspx.
A brief (and incomplete) summary of the changed rules appears below. This briefing then illustrates a few of the ways that the change in lease accounting can create problems for a loan agreement that covers periods both before and after the effective date of the new rules. Finally, we discuss approaches that borrowers and lenders may wish to consider when negotiating loan facilities that may still be in place in 2019.

Overview of the Revised Lease Accounting Rules

Current Lease Accounting

The basic rules for lease accounting currently appear primarily in FAS 133 (for U.S. GAAP) and IAS 17 (for IFRS). Under current rules, for GAAP purposes, leases are either classified as “operating leases” or “capital leases” while for IFRS purposes leases are either “operating leases” or “finance leases.” Under both GAAP and IFRS, operating leases currently are not reflected on the balance sheet of either a lessee or a lessor and rent is expensed by the lessee and included by the lessor on a straight line basis over the term of the lease.

Capital leases and finance leases, on the other hand, do appear on the balance sheet of both the lessor and the lessee and are treated in some respects like a financing transaction. While the rules for determining whether a lease is a capital lease under GAAP or a finance lease under IFRS are not the same, in practice a capital lease is usually also a finance lease and vice versa.

Lessee Accounting Under the New Rules

Under the new rules, a lessee will generally report an asset (the “right of use” of the property under lease) and a liability (the present value of future rent) for a lease which is subject to these rules. Rent payments are treated partly as “amortization” of the right of use and partly as interest charged on the rent payable. One consequence of this approach is that a level-payment lease may not result in level expensing.

Lessor Accounting Under the New Rules

A lessor will restate its balance sheet to split what is now a single asset (the item being leased) into two assets: the present value of the rent receivable and the present value of the expected value of the asset at the end of the lease (the “residual”). The lessor will compute its income from the lease basically by treating the receivable as a “loan” that earns interest and the rent as payment of this interest and amortization of the receivable and will also adjust the residual annually. This may also cause income from a level-payment lease to be reported in a non-level pattern.

Transactions Excepted from the New Lease Accounting Rules

The new rules will not apply to:

- Short term leases (basically leases of 12 months or less) and
- Leases of intangible assets.

The GAAP rules will also provide special treatment for certain real estate leases. The two exposure drafts also make an attempt to clarify when a contract (or part of a contract) will not be treated as a lease at all.

3 The U.S. GAAP rules are codified into Accounting Standards Codification section 840.
4 Note that characterization of a given lease by the lessee and the lessor may be different: the lease may be an operating lease to one of the parties and a capital lease or finance lease to the other.
5 Under the IFRS rules, certain small leases will also be excepted.

Transition
The rules will apply to all leases from the effective date. While there are some transition rules (designed mostly to allow companies to avoid some new present value calculations under interest rates in effect at the effective date) none of the transition rules appear to eliminate any of the issues the changes raise in financing documentation.

Impact on Loans
The main impact is on loans where the covenant ratios and other loan restrictions are based on standard financial statements or standard accounting principles. The shift to the new lease accounting will impact the size of balance sheet assets and liabilities, the type of liabilities and the income pattern of the lessee and the accounting characterization of lease income and deductions, among other effects.

The lease accounting changes can impact any loan covenants that tie to either GAAP or IFRS. A few of the most common examples of potential issues are:

1. Debt to Equity Ratio
   Many loans contain a borrower covenant that the ratio of debt to equity will not exceed some agreed limit. “Debt” for this purpose may mean “liabilities” as shown on a balance sheet computed in accordance with GAAP or IFRS and “Equity” may be the “Net Worth” on the same balance sheet. If the borrower is the lessee under operating leases and the present value of the rent due under those operating leases is large enough, the borrower may go from meeting the covenant to failing it when the lease accounting rules become effective, without any change in its business operations. This is because the present value of lease rent under the “operating leases” will now be added to what was previously “Debt” but there will be no corresponding change to the amount of “Equity.”

   For example, if a borrower is required to maintain a debt to equity ratio of 1.25:1 or less, consider a borrower who, under today’s rules, has balance sheet assets of 200x and liabilities of 100x. The borrower’s net worth is 100x and the debt to equity ratio is 1:1, which meets the requirement. If the present value of the future rent on all operating leases owed by the borrower is 50x, however, on the day the new lease accounting rules become effective the company’s debt to equity ratio will become 1.5 to 1, and the borrower will fail the covenant even though there has been no change in the borrower’s operations or results.

2. Prohibition on Additional Financial Indebtedness
   The issues raised by the change in accounting rules may not only be adverse to a borrower. Many loans, for example, prohibit the borrower from incurring additional “Indebtedness.” In order to avoid the borrower effectively “borrowing” to buy other assets by using lease financings, the definition of the relevant term “Indebtedness” often includes any lease or hire agreement which is classified as a capital lease under GAAP or a finance lease under IFRS (depending on which accounting standard the borrower is using). Under current disclosure rules, capital leases or finance leases are separately disclosed on current balance sheets under the GAAP and IFRS rules, so this is an administrable rule.

   However, once the new lease accounting rules come into effect, GAAP will no longer have a definition of “capital lease” and IFRS will no longer have a definition of “finance lease.” The accountants auditing a company will not need
to determine what leases would have fallen into this category and no financial disclosure of the amount of such leases will be shown.

This means that when the new lease accounting rules become effective, a borrower under a loan with such a covenant will suddenly be able to incur obligations that it would previously have been prohibited from entering into because a lease that would have been “Indebtedness” prior to the effective date will no longer be “Indebtedness” after it.

3. Other Impacts
The two examples above are by no means a complete picture of the impact the changes may have on loan agreements. The changes in the way lease rents are accounted for by the lessee may, for example, affect overall income in some years in ways that are not expected. Similarly, an increase in the “interest” expense of the lessee for accounting purposes may change the meaning of covenants that are based on restrictions on interest expense.

Things to Consider in Negotiating a Loan Agreement Now
A borrower or a lender negotiating a loan agreement between now and 2019 should consider the potential impact of the future changes in the way leases are accounted for. It may be wise to provision for the change in lease accounting now.

It is not realistic today to try to provide explicit rules for all possible issues that may arise from the change in lease accounting rules. The rules are too new and there is no experience with actual companies operating and producing financial statements under the new rules.

A better approach to avoiding the problems caused by the prospective change to lease accounting is to provide in the loan agreement that the accounting rules in effect at the time the loan agreement was entered into will govern all definitions that make reference to accounting standards. This is a “complete” solution to the problem in that it covers both obvious issues and ones that are not yet expected. It is a good short-term practical solution to the problem as well, but it may not be easy to apply this solution over a period of many years. Once the accounting rules change, in order to apply this “work-under-the-old-rules” provision, the borrower will have to prepare both the new financial statements and “as-if” financial statements using the old rules. In order to validate the “as-if” financial statements, the borrower will have to provide a reconciliation of the two statements. The lender is likely to need to have the reconciliation vetted by an outside accountant (presumably, the company’s auditors) because reconciliation is only partly a mathematical exercise. It will also involve judgements. For example, the borrower will have to determine the classification of leases under the “old” accounting rules, possibly long after the rules have ceased to be in effect. As new types of transactions come along, it will become harder to determine whether the new structures “would have been” classified as capital or operating leases.

For this reason, while this approach is often a good first step, the parties may also want to try to deal with the post-effective date world without needing to create hypothetical financial statements for the life of the loan. In theory, one could try to revise each definition and covenant to take into account the new rules when they become effective. This may be impractical however, given the lack of experience in interpreting the new rules. A reasonable alternative is to provide that the parties will
try to adjust critical covenants and definitions after the effective date to reflect the changes in lease accounting, but to acknowledge that the parties may not agree on how to do this and may have to continue to operate using hypothetical financial statements. Although this sounds like a meaningless “agreement to agree”, in practice, in the years after 2019, the relevant loan market will have to find an answer to how to deal with the issues posed by the revised lease accounting, and the new standard that evolves may well inform the negotiation for revising pre-2019 agreements.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.

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