JO Knows How to Account for Bank Covenants

OCTOBER 26, 2022 | BY: THE AUDIT TEAM

With the implementation of the new lease accounting standard upon us (Accounting Standards Codification 842, Leases (ASC 842)), and the impact that this new standard could potentially have on the financial statements for so many entities, we have so far focused on providing entities with a high level understanding of the new lease standard. Thus far in our series, we have discussed the technical aspects of the standard, from how to identify a lease, determine the key inputs (i.e. lease term, lease payments and discount rate) necessary to determine the type of lease and ultimately, calculate and account for the right of use asset and lease liability.

In this issue, we will discuss the impact to key financial ratios, which are often key financial covenants included in financing arrangements. The most substantive change of the new standard, as previously discussed, is the addition of operating leases to an entities balance sheet. This change will include right of use assets as noncurrent assets, and lease liabilities as both current and noncurrent liabilities (the current portion refers to the amount payable in the succeeding twelve months post balance sheet date). All other things equal, this change, at least optically, has an adverse effect on many key financial ratios.

Because a portion of the liability will be presented as current, this results in a reduced working capital and a lower current and quick ratio, just to identify a few, and the addition of the entire lease liability will increase the leverage ratio. These changes, without proper context, will appear unfavorable. While the proper context may be easy to provide, a simple explanation may not be enough to resolve a covenant violation. Given the potential magnitude of underlying accounting (think multi-year real estate lease), covenant violations resulting from exceeding the minimum or maximum on a specified ratio may occur irrespective of the operational performance of the entity.

Debt agreements and other similar arrangement are sometimes written with so-called “GAAP as-is” clauses, which allow the measurement of key financial ratios based on the accounting standards in effect at the time the agreement was executed. In other instances, the agreements call for best faith negotiations of revised terms in the event of regulatory changes (such as accounting rules). Absent similar language, an entity would likely be required to measure its covenants inclusive of the additional asset and liability on the balance sheet. Thus, an entity should be discussing the impact of the new standard with its lender now. There is opportunity as the summer turns to fall to be proactive and work towards an amicable solution, one that may not be available if the conversation begins in the days before a financial statement deadline.

Conclusion

Because the changes resulting from the new standard are not unique to certain industries or types of organizations, the existence of said changes are likely to be understood by your lender. Nonetheless, the time is now to review and discuss the impact of these changes to your entity’s financial statements.

Effective Date

ASC 842 is effective for private companies and nonprofit organizations with annual reporting periods beginning after December 15, 2021 and interim periods within fiscal years starting after December 15, 2022.

To learn more about Johnson O’Connor’s Accounting & Attest services, **click here**.

RELATED SERVICES

Audit & Assurance

