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The Impact of New Lease Standards on Debt Covenants

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For accounting firms, this is the calm before the storm.

The year is over, and it's likely to be a few weeks before year-end financial reports start coming in from your clients.

But particularly if your clients are primarily private companies, there's a task you can do right now to save both yourself and them problems later: Make sure your clients talk to their banks about how the ASC 842 lease accounting standard could affect their debt covenants.

What the ASC 842 lease accounting standard could mean to your clients

Debt covenants are restrictions that lenders such as banks and other creditors include in their lending agreements to limit the borrower's actions. If borrowers don't follow these restrictions, that can result in a debt covenant violation.

The ASC 842 lease accounting standard requires companies to add operating leases to their balance sheets with the purpose of increasing financial transparency. The present value of future lease payments is added to short- and long-term liabilities, and that lease, in turn, becomes a long-term asset. This doesn't impact the income statement.

Even though a company's operations and results haven't changed, adding leases to financial statements often materially alters the balance sheet. Many debt covenants include requirements on various ratios between earnings, assets and liabilities. Adding leases to the balance sheet may adversely affect those ratios.

The result can be a debt covenant violation.

Newly required for private companies

Clients, particularly small private ones, won't necessarily be aware of this new requirement. While public companies have been dealing with ASC 842 for a while, nonpublic companies first need to adopt the standard for their fiscal years starting after December 15, 2021. It's been a volatile time, when companies have been preoccupied with the economy, supply chains and rising interest rates, so they may not be aware that changing lease accounting standards could affect debt covenants.

Even clients that already know may not yet have taken steps to address the issue. Clients may be concerned about the bank's response, thinking that being in this position indicates some dereliction on their part. They need to be reassured that the situation isn't a problem or their fault – but failing to deal with it could be.

Especially if you have clients with a tendency to put things off, you can provide great value by urging them to apprise their bank as soon as possible before year-end financials are issued.

Banks are waiting, too

It's especially important for clients to approach their banks because the banks may not be proactive about approaching clients that potentially have this problem. While the bank can take a financial statement and analyze it after it has been prepared and look for the effect of accounting changes, it doesn't typically check to see how accounting changes might affect its customers. In most cases, banks are waiting for their customers to inform them.

Now, it's possible that larger banks with public companies as customers – that already went through this a couple of years ago – might reach out to their private company customers as well, or even have already made changes to their debt covenants to reflect the effects of ASC 842 on lease accounting standards. But many smaller private companies deal with community banks, which haven't had to deal with the ASC 842 debt covenant issue yet. This may be a new situation for the bank to confront as well.

Avoiding debt covenant violations

The problem is, once your clients have already turned in their financial reports, adjusting the debt covenant is a much more complicated process to fix, especially if it gets recorded as a violation. Once a debt covenant violation gets recorded, it becomes a much more urgent situation.

Penalties for debt covenant violations can include increased reporting requirements, higher interest rates or losing access to credit altogether. This can hurt a client's business.

Your clients need to be reassured that there's no rule about how bank covenants are calculated. Banks decide what is and isn't included in a debt covenant – and they can change the debt covenant as well. That includes the various ratios the debt covenant uses. So, if ASC 842 negatively affects your clients' debt covenant, banks can adjust the debt covenant to accommodate this.

The important thing to remember is that banks and lenders don't like to be surprised. They can make notes and adjustments, but when they're surprised, that's when they react poorly. That's why it's important to ensure that your clients are talking to their banks first.

Talking to the bank before financial statements are issued makes the debt covenant issue simpler. Your clients are in the process of doing their year-end reports, and by now they should have an idea of how the ASC 842 lease accounting standard will affect them.

All they need to do is also look at their debt covenants to see whether there might be an issue and, if necessary, approach their banks about any adjustments to be made. It doesn't make your clients look bad – it makes them look prepared.

The upshot is this: Your clients may have already considered how ASC 842 will affect their debt covenants. Even if they haven't, it's possible their banks have already modified debt covenants to limit a possible adverse effect due to ASC 842. But if neither of these things have happened, your clients could have a major issue during your busiest time of the year. Make sure your clients know that they should check this while they still have time to talk to their banks and forestall any issues.

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