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CFO JOURNAL

CFOs Fret About Loans on the Eve of New Accounting Rule

Companies will be required to report operating leases on their balance sheets next year, a shift that can trip loan covenants and cause lenders to recall the debts

By Tatyana Shumsky

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A change in how companies account for leases is threatening to upend corporate-loan agreements and prompting finance chiefs to search for solutions.

Next year, public companies will be required to report operating leases—for everything from office space to jet engines—as liabilities. An estimated $3.3 trillion in leases, currently buried in the footnotes of financial statements, are expected to find their way onto corporate balance sheets next year because of the change that goes into effect at the end of the year.

That will disturb corporate debt-to-earnings ratios, a metric lenders use to set loan covenants that protect against defaults. The new accounting method could trigger those covenants—even if nothing else about a company's financials has changed—and erode the borrowing power of some companies.

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As a result, finance chiefs are pressed with a choice: renegotiate loan terms, provide lenders with specialized financial reports, or run the risk of having debts called by lenders.

“There will be legal fees and bank fees and all kinds of things” associated with any change to loan terms, said Steven Michaels, the chief financial officer of Aaron’s Inc., an Atlanta-based furniture retailer.

Aaron’s is among a handful of public companies to have disclosed loan complications stemming from the new lease rules. But more are expected. Many companies aren’t far enough along in implementing the new standards to even know whether their debts will be affected.

The scenario illustrates the complications finance teams have faced as a result of a more than a decade-old push to align global accounting standards of the U.S. Financial Accounting Standards Board and the International Accounting Standards Board.

The updated lease-accounting rules are intended to improve financial transparency for investors and lenders. But for companies, compliance requires time and money—to build databases of their operating leases, put in place new accounting processes and software, and train staff to follow the new rules—and may yield no financial benefit.

“It creates extra work for already lean financial reporting groups,” said Sheri Wyatt, a partner at accounting firm PricewaterhouseCoopers LLP, who helps companies implement the new standard.

Since the new lease-accounting rules could make some companies appear more indebted, some CFOs are seeking to amend loan terms or getting legal advice to determine how covenants could be interpreted.

Others may undergo the arduous process of producing one set of financials for regulators, which apply the new standard, and another set of documents for lenders, which would follow accounting standards that were frozen in place when the loan terms were made.

Aaron’s, the furniture retailer, decided that extra work is better than extra money spent on legal and bank fees in a renegotiation, said Mr. Michaels, the finance chief.

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The company's existing debt contains covenants that are guided by U.S. Generally Accepted Accounting Principles that were in place in 2017. The credit facilities come due in 2022. Until then, Aaron's is prepared to provide lenders with a set of reports using the accounting rules that are valid under the terms of the loan but do not conform to the revised leasing standard. The financial report it prepares for regulators and investors, meanwhile, will follow the updated accounting standard.

"This was the path of lesser resistance," Mr. Michaels said. "It also allows our bank group to get some data points on what other companies are doing so we can learn from others what has worked and what has been problematic."

Athenahealth chose to renegotiate. In March, the company modified an existing $500 million loan so that covenants would align with new accounting standards. Doing so prevented the company from having to maintain a separate set of books for calculating covenants for its credit facility, an Athenahealth spokeswoman said in a statement.

Other companies are stipulating which leases can be included as liabilities used to calculate covenants.

Nutrition company Herbalife Nutrition Ltd. in August closed a $1.25 billion credit facility. It included a provision that lenders only count capital leases using current accounting rules when calculating covenants, regardless of future changes in accounting rules.

"We as a company recognized that we had this change coming and we wanted to make sure that it doesn't affect our covenants," said John DeSimone, co-president and former CFO at Herbalife.

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