

# ClientAlert

## Bank Finance

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### Impact on Credit Agreements of the Proposed Change to Accounting Treatment of Leases

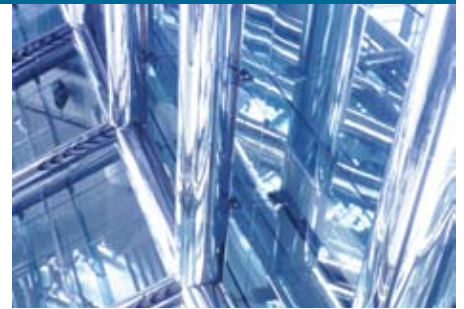
The International Accounting Standards Board and the US Financial Accounting Standards Board have recently issued a joint exposure draft relating to the accounting treatment of leases that, if put into effect as proposed, would fundamentally change accounting and reporting of lease arrangements in financial statements. Comments are due by December 15, 2010, with the intention that a new standard on lease accounting would be issued in 2011.

If the proposals are put into effect as drafted, the current dual accounting system for operating and capital leases will be abolished: Borrowers and their lenders will need to consider the effect of this on their credit agreements and in particular on any financial covenants, financial definitions and restrictions relating to indebtedness contained in such agreements.

#### What Changes Do the Proposals Envisage and Why Do These Matter to Lenders?

While industries where operating leases are most extensively used (retailers, hoteliers, aircraft and shipping) will be most affected, the rule change will impact any company that currently accounts for any of its leases as "operating leases."

The extent to which leases are taken into account for the purpose of calculating financial covenant ratios and indebtedness incurrence covenants in credit agreements usually depends on the accounting treatment attributed to the particular lease in the preparation of the company's financial statements. In most cases, the definitions and financial covenants are drafted by reference to the accounting term "capital lease."



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Under the current accounting rules, leases are classified as either operating leases or capital leases. For the lessee, operating leases remain off-balance sheet with any lease payments being charged to the profit and loss account (P&L) as an operating expense and therefore not typically considered as debt for the purpose of calculating either the indebtedness covenant or the financial covenants under credit agreements. Conversely, capital leases are recognized on the balance sheet and consequently are typically included as debt in the financial covenant calculations under credit agreements.

The proposals envisage abolishing this dual system and adopting a unified approach where all leases are accounted for in a consistent manner with some similarities to the current capital lease treatment. Each lease will need to be considered individually and factors such as discount rates, the period of the lease and lease payments, together with any residual value guarantees or penalties, will all play a part in determining the value and the accounting treatment of any particular lease which will in turn determine the effect of such on the relevant covenants. As a general rule, the following will apply:

- i. the right to use the asset underlying the lease will appear on the balance sheet as an asset, with the value of the asset reducing over time as the lease term expires;
- ii. the present value of future payments will appear on the balance sheet as a liability and again will reduce over time, but not necessarily at the same rate that the lease asset is depreciated;
- iii. the interest element of the lease will be charged to the P&L as a finance expense and, once again, this will reduce over time as the amount of the future capital payments reduce; and
- iv. there will be an annual depreciation charge to the P&L over the life of the lease equal to the reduction in the asset value referred to in clause (i) above.

All leases will be referred to as “leases” with the accounting terms “operating lease” and “capital lease” becoming obsolete.

## What Is the Effect on Financial Covenants?

As noted, the current dual treatment of leases is reflected in the drafting of financial covenants, related definitions and indebtedness incurrence covenants in credit agreements, which typically purport to capture only the obligations in respect of capital leases. Any restrictions or limits relating to indebtedness, for example a permitted basket for capitalized lease obligations, will therefore need to be reviewed.

Lenders may argue, following the proposed change and the abolition of the capital lease classification, that any reference in financial definitions to capital leases should be interpreted to include any and all leases. Conversely, although somewhat extreme, borrowers could assert that no leases are included.

The potential impact of the proposed change on certain financial definitions and financial covenants is summarized below:

### EBITDA

EBITDA, used in the leverage and interest coverage ratios and as a base for the fixed-charge coverage ratio, is currently reduced by rental payments on operating leases, these being deducted as a general operating expense of the company. Under the proposals, this will no longer be the case. The effect on EBITDA will therefore be positive. EBIT, while benefiting from the reduced operating expense will, however, be negatively impacted to the extent of the increased depreciation charge and interest expense that will result from the change (i.e., the amounts referred to in clauses (iii) and (iv) above).

### Indebtedness and Total Debt

The indebtedness definition, used to restrict the amount of indebtedness the group may incur or as a cross-default trigger and the total or consolidated debt definition, used for the purpose of calculating leverage ratios, capture only the capital element of payments under any lease agreement which would, in accordance with existing accounting principles, be treated as a capital lease. Currently, therefore, by definition this excludes any amount payable in respect of operating leases. Under the proposals, as there will no longer be a distinction between “operating” and “capital” leases, both the indebtedness definition and the total or consolidated debt definition could be determined to include any amount payable under any lease that is accounted for as a liability in the balance sheet (i.e., the present value amount of any future capital payments referred to in clause (ii) above).

### Interest Expense

Definitions relating to determining interest expense, used for the purpose of interest coverage and fixed-charge coverage ratios, generally purport to capture only the interest element of payments in respect of capital leases, currently excluding any rental payments under an operating lease. Under the proposals, interest expense could capture the interest element of any lease payment.

### Leverage Ratio (Total Debt to EBITDA)

The effect of all leases (including operating leases) being captured on the balance sheet would be to increase both total debt and EBITDA.<sup>1</sup> Conversely, if no leases are captured on the balance sheet, total debt would decrease while EBITDA would increase.

### Interest Coverage Ratio (EBITDA to Interest Expense)

The effect of all leases being captured on the balance sheet would be to increase both EBITDA and interest expense, while, if no leases are captured on the balance sheet, EBITDA would increase, whereas interest expense would decrease.

### Fixed-Charge Coverage Ratio (EBITDA to Fixed Charges)

The effect of all leases being captured on the balance sheet would be to increase EBITDA, whereas the fixed charges would likely remain unchanged subject to the terms of the applicable credit agreement. To the extent no leases are captured on the balance sheet, EBITDA would increase while fixed charges would likely remain the same, subject to the terms of the applicable credit agreement.

## Will These Changes to Classification of Leases Trigger a Breach of Credit Agreements?

The extent to which the changes will be taken into account when calculating the financial covenants will depend upon the terms of the credit agreement and whether the borrower's compliance with financial covenants is:

- i. on the same basis as the original financial statements (i.e., the first set of accounts delivered to the agent on the closing date), referred to herein as "frozen GAAP" and standard in leveraged finance transactions;
- ii. in accordance with GAAP from time to time unless there is a change in GAAP that would affect the computation of any financial ratio or requirement in the credit agreement, at which point the borrower, administrative agent or requisite lenders may at its or their option request an amendment to the credit agreement to preserve the original intent in light of such change in GAAP, referred to herein as "floating GAAP with opt-out"; or
- iii. in accordance with GAAP from time to time, referred to herein as "floating GAAP"; which is more typically found in investment-grade transactions.

Under a frozen GAAP provision, it is usual that each set of financial statements has to be prepared on the same basis as the original financial statements, unless there has been a change in GAAP. Where there has been a change, the borrower is required to reflect the changes in GAAP, but in addition the borrower must provide a reconciliation statement to enable the lenders to determine whether the financial covenants have been met on the basis on which the financial covenants were set. In other words, the change in accounting treatment will not affect the calculation of the financial covenants. Under floating GAAP with opt-out, changes in accounting treatment under GAAP will be taken into account in both the preparation of the financial statements and the calculation of the financial ratios unless the borrower, administrative agent or requisite lenders opt-out of such treatment by requesting an amendment to the ratios to preserve the original intent of the credit agreement, which amendment may have to be approved by the requisite lenders under the credit agreement. Under floating GAAP with opt-out, there is usually a rule that until an amendment as described in the preceding sentence is approved, frozen GAAP will apply. If, however, the credit agreement provides for financial statements to be prepared on the basis of floating GAAP with no opt-out, changes in accounting treatment will be taken into account without adjustment to the covenant levels set forth in the respective credit agreement.

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<sup>1</sup> It cannot be assumed that the increase in EBITDA will balance the increase in total debt. Where EBIT, not EBITDA, is used, there will be a deduction to the extent of the increased depreciated charge and interest expense resulting from the change in accounting treatment of leases.

As a general matter, it is likely that the changes with respect to the treatment of leases as described herein could only trigger a breach of those credit agreements which have floating GAAP without an opt-out provision. In such cases, the requirements of the respective credit agreement and covenant levels will need to be examined to determine whether a potential breach is likely.

## Conclusion

Parties will be well-advised to prepare for the proposed accounting change with respect to the treatment of leases and to consider the likely impact on their financing documentation. This will enable parties to address the issues in advance of the change taking effect.

## Existing Deals

If the proposed accounting changes are adopted, lenders and borrowers will need to review their credit agreements to ascertain whether the changes to the accounting treatment of leases will result in leases which have previously been ignored for the purposes of any indebtedness covenant and/or the financial covenants being brought into account. To the extent that they are, a consideration of any floating or, as appropriate, frozen GAAP provisions will be necessary to determine the requisite steps to be taken:

- i. where credit agreements provide for floating GAAP or floating GAAP with opt-out, there is clearly a potential issue and there may be a need for amendment, waiver or covenant adjustments to be effected to take account of the changes; and
- ii. where credit agreements provide for frozen GAAP, although there may not be an immediate impact, it may be unclear whether any financial definitions, financial covenants or indebtedness incurrence covenants are "frozen" and even where such items are "frozen," the delivery of reconciliation statements would require the borrower to maintain two sets of accounts which is not likely to form a viable long-term solution. In credit agreements with frozen GAAP, the borrower may wish to avoid having to provide reconciliations on an ongoing basis to GAAP as in effect before giving effect to the changes in lease treatment, and in such cases may wish to effect a technical amendment so that it is reporting, and complying with covenants, on the basis of GAAP as modified for the change in the treatment of leases.

## New Deals

Lenders and borrowers entering into new or amended credit agreements should consider the various outcomes outlined above in respect of the reclassification of leases and ensure that the relevant provisions are drafted so as to anticipate the change and to result in those leases which they agree should be treated as a liability of the company being properly included as such.

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