How Pronouncements Affect Covenants

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Generally accepted accounting principles (GAAP) are frequently described in most loan agreements. Financial institutions traditionally have written a broad range of financial covenants into loan documents that allow the banks to monitor the borrower's financial position. These financial covenants allow the financial institution to react to a possible deteriorating financial position of the borrower, thus enabling the institution to reduce credit or consider the loan in default and demand repayment.

Debt Covenants

Debt covenants can be either financial, nonfinancial or both. Financial statements to be submitted within so many days, a provision that all taxes and insurance have been paid or environmental compliance are examples of a nonfinancial covenant. In most loan documents, financial statements often include the term "prepared in accordance with generally accepted accounting principles" or "accounting principles generally accepted in the United States."

Financial Covenants

Financial covenants typically consist of several ratios that the creditor deems relevant to the loan. The borrower must compute these on an annual or more-frequent basis. These ratios are often submitted to the lender along with a certification and the financial statements that support the underlying data. As GAAP evolves, computing covenants become affected which could result in a company unintentionally failing to meet the financial covenants as defined by the creditor. This is all because the loan agreement mandates that the financial statements must be in accordance with GAAP.

GAAP Changes

For a company to maintain its loan in good standing and prevent default, it must not only submit financial statements, but the financial statements must be in accordance with GAAP, not other comprehensive basis of accounting, cash basis or income tax basis. Hence, whenever changes in GAAP occur, the company must adopt the new pronouncement or face automatic noncompliance with the loan provisions. Noncompliance means default; default means reclassification of the long-term portion of the debt to a current liability which creates additional problems.

Example 1

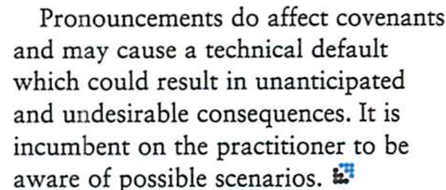
Let's examine how a GAAP change can affect covenants. One example is the consolidation of variable interest entities. Company A, the primary beneficiary, has a loan that mandates a debt service coverage ratio (DSCR) minimum of 1.5. Under this ratio, earnings before income, taxes, depreciation and amortization (EBITDA) must exceed 1.5 times the current portion of long-term debt plus interest expense. Company A easily meets this requirement. Enter Financial Accounting Standards

Board ASC 810-10, aka FIN 46, *Consolidation of Variable Interest Entities*. FIN 46 defines Company A as the primary beneficiary of a rental real estate entity (Company B) and requires consolidation with Company B (the variable interest entity). Company B has a mortgage on its building with a sizable current portion. Under the bank's formula for computing DSCR, Company A now fails to meet the minimum coverage of 1.5 due to the increased current portion of debt.

Example 2

Imagine Company B doesn't exist and Company A leases its manufacturing facilities from an unrelated landlord where FASB ASC 810-10 does not apply. Again, Company A has a loan that requires a DSCR minimum of 1.5. Company A has no difficulty in meeting this ratio under current lease accounting pronouncements. Under the current lease accounting treatment, the leased asset and related obligation are not on the balance sheet. Approximately two years ago, the FASB and the International Accounting Standards Board began work on an exposure draft regarding leasing activities. This proposed standard would redefine leases by requiring a liability on the balance sheet equal to the present value of the lease payments. This new liability, or a portion of it, will factor into Company A's financial covenant, increasing the denominator and potentially causing the coverage ratio to fall below 1.5 resulting in a technical default under the terms of the loan agreement.

Pronouncements do affect covenants and may cause a technical default which could result in unanticipated and undesirable consequences. It is incumbent on the practitioner to be aware of possible scenarios.



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