INSIGHTS FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

ARE CREDIT ADMINISTRATORS READY TO ANALYZE BORROWER FINANCIAL STATEMENTS IN COMPLIANCE WITH FASB ASC 842?

By Steven O'Donnell

LOAN UNDERWRITING AND ON-GOING MONITORING

Underwriting, in its most summarized definition, is the process utilized by lenders to determine the credit worthiness of a potential borrower. When performing this critical function, lenders use a varying degree of information to decide whether to extend credit to a customer. At the core of this analysis is obtaining the borrower's financial statements to assist the lender in evaluating:

- The borrower's current financial position
- The feasibility of the business model
- The type of collateral securing the loan
- The terms of the loan that the lender may offer
- And most importantly, the ability of the borrower to repay the loan

Then, if granting credit, lenders establish affirmative financial covenants by which to measure the borrower's current and ongoing financial health—such as:

Working Capital
- Current assets minus current liabilities

Current Ratio
- Current assets divided by current liabilities

Debt to Equity Ratio
- Total liabilities divided by total shareholders' equity

Debt Service Coverage Ratio
- Net operating income divided by annual debt payments

Fixed Charge Coverage Ratio
- Earnings before interest, taxes and fixed charges before taxes divided by fixed charges before tax plus interest

EBITDA
- Earnings before interest, taxes, depreciation and amortization

Note: The above is not intended to be all inclusive, but rather focuses on ratios that may be impacted by FASB ASC 842.

OVERVIEW OF THE ACCOUNTING STANDARD

Under prior U.S. Generally Accepted Accounting Principles, the key determination was whether a lease was an operating lease or a capital lease, as that drove if it was recognized on the balance sheet. In early February 2016, the Financial Accounting Standards Board ("FASB" or "the Board") issued its highly-anticipated leasing standard amendment in [Accounting Standard Update ("ASU") 2016-02, as subsequently amended ("Topic 842" or "the new standard")]() for both lessees and lessors. Under the new standard's core principle, a lessee will need to recognize right-of-use ("ROU") assets and related lease liabilities on the balance sheet for all arrangements with terms longer than 12 months. This modification will significantly impact the balance sheet for lessees and the pattern of expense recognition in the income statement, as it depends on a lease's classification.

The following table summarizes lessee accounting for both finance and operating leases:

FINANCIAL STATEMENT	FINANCE LEASE	OPERATING LEASE
Balance Sheet	Recognize ROU asset and lease liability at the commencement date of the lease. The lease liability, initially and subsequently, is measured at the present value of the remaining lease payments. The ROU asset initially is measured at the amount of the lease liability recognized, plus initial direct costs and prepaid lease payments, less lease incentives received. The ROU asset is subsequently amortized generally on a straight-line basis.	Recognize ROU asset and lease liability at the commencement date of the lease. The initial and subsequent measurement of the lease liability, and the initial measurement of the ROU asset, are the same as for finance leases. The ROU asset is subsequently amortized in such a way that the lease cost is recognized generally on a straight-line basis over the lease term in the income statement.
Income Statement	Recognize interest on the lease liability separately from amortization of the ROU asset.	Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
Cash Flows	Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.	Classify all cash payments for leases within operating activities.

EFFECTIVE DATE

The new standard is effective for public business entities for fiscal years beginning after December 15, 2018 (which is 2019 for calendar year companies), and for interim periods within those fiscal years. For all other companies, the new standard is effective for fiscal years beginning after December 15, 2019, and interim periods beginning the following year.

Therefore, lenders will start receiving financial statements from current and prospective borrowers that reflect the adoption of this new standard between 2019 and 2021, with the exact timing dependent on the ownership structure of the borrower, the timing of the issuance of their financial statements and the timing of when financial statements are provided to the lender.

For an in-depth discussion on the new accounting standard, and its impact on financial statements, refer to our ***BDO Knows: FASB newsletter on Topic 842 leases***.

Tentative FASB Decision: In FASB's July 17, 2019 meeting, the Board tentatively decided to delay the effective date of the new standard by an additional year for most private entities. Additional details regarding the FASB's tentative decisions are available **here**. Tentative Board decisions may be changed at future Board meetings.

ILLUSTRATION OF IMPACT ON BORROWER FINANCIAL STATEMENTS

The following balance sheet illustrates the impact of adopting FASB ASC 842 for a retailer who has numerous store locations that were classified as operating leases under FASB ASC 840:

	AFTER ADOPTION	BEFORE ADOPTION
Assets		
Current assets		
Cash and cash equivalents	$ 1,600	$ 1,600
Short-term investments	–	–
Receivables, net	800	800
Merchandise inventories	5,200	5,200
Other current assets	500	500
Total current assets	8,100	8,100
Property and equipment, net	2,300	2,300
Operating lease assets	2,700	–
Goodwill	900	900
Other assets	600	600
Total assets	$ 14,600	$ 11,900
Liabilities and equity		
Current liabilities		
Accounts payable	$ 4,700	$ 4,700
Unredeemed gift card liabilities	300	300
Deferred revenue	400	400
Accrued compensation and related expenses	300	300
Accrued liabilities	800	800
Current portion of operating lease liabilities	700	–
Current portion of long-term debt	50	50
Total current liabilities	7,250	6,550
Long-term liabilities	650	650
Long-term operating lease liabilities	2,100	–
Long-term debt	1,200	1,200
Contingencies (Note 13)		
Equity		
Common stock	100	100
Retained earnings	3,000	3,100
Accumulated other comprehensive income	300	300
Total equity	3,400	3,500
Total liabilities and equity	$ 14,600	$ 11,900

BDO RECOMMENDATIONS:

1. **Education** – All members of Credit Administration and Loan Operations that utilize financial statements should be educated on the new accounting standard, and its impact on borrowers' financial statements and associated affirmative financial covenants.

2. **Measuring affirmative financial covenants** – While covenant thresholds can be individually adjusted for each borrower to accommodate for the impact of this new standard, a systematic approach will likely be more efficient and effective for obtaining consistent underwriting results and ongoing credit monitoring across the various loan portfolios. A simple way to do this would be to adjust how the financial covenants are calculated, by removing the ROU asset and lease liability from the equations. This approach will also prevent the need to adjust any preestablished minimum thresholds outlined in the credit policies.

To learn more about how the new accounting standard may impact your business, contact Steven O'Donnell, Assurance Partner at BDO, at sodonnell@bdo.com.

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