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Debt Covenant Disclosures

Article Analyzed: Sherer, Paul. “Now Playing in Bankruptcy Court: Carmike, Wachovia Reach the Brink in Battle Over Terms.” *Wall Street Journal*, New York, N.Y. Sept. 6, 2000.

In August of 2000, Carmike Cinemas, one of the United States’ largest cinema companies, filed for Chapter 11 bankruptcy protection. This filing shocked many investors and analysts, since the corporation was producing positive cash flows and was growing rapidly. The company’s aggressive growth, which required heavy borrowing, is one of the likely causes of the bankruptcy filing. Early in 2000, Carmike violated its debt covenants specified in its bank loans, which gave the banks the right to call their loans, pushing the company towards bankruptcy.

Debt covenants have an immense affect on the viability of corporations. Given the impact of these agreements, the Financial Accounting Standards Board (FASB) has an obligation to see that the public remains informed by expressly requiring financial statement disclosures of all material debt covenants used by publicly-traded companies. Statements of Financial Accounting Concepts No. 1 states that financial reports should provide information "that is useful in making business and economic decisions." Current GAAP requires full and fair disclosure of relevant information; however, disclosure of debt covenants is not expressly required except in instances where there has been a covenant violation.

Under existing GAAP regulation, FAS No. 78, "Classification of Obligations that Are Callable by the Creditor," dictates accounting standards for dealing with violations of debt covenants. It requires that all long-term obligations that are or will be callable by the creditor because of the debtor's violation of a provision in the debt agreement shall be classified as current liabilities at the balance sheet date. A callable obligation does not have to be recorded as a current liability if the creditor waives the right to demand repayment after the balance sheet date but before the financial statements are issued or if the covenant allows for a grace period and the violation is expected to be corrected within that time-frame. FAS No. 78 does an adequate job of regulating debt classifications after covenant violations; however, it still neither provides investors this material information until after the covenant has been infringed nor does it require the companies to release the actual terms of the agreement.

Debt covenants can tremendously influence management's decisions. Under a covenant, the business is committed to a stream of interest and principal payments, and it must maintain all the required financial accounting ratios and other terms expressed in the agreement. Creditors use debt covenants as an attempt to better secure their position. When a covenant violation occurs, creditors might increase borrowing rates, require additional collateral and/or constraints, or terminate the credit. Thus, these breaches may have significant cash flow implications. Given the risks of violating a debt covenant, managers must always contemplate the effect on the ratios and terms in the covenant when making decisions. For example, management might have to consider the effects of capital purchases on the return on assets (ROA) ratio.

Investment decisions in Carmike Cinemas might have been significantly different had its debt covenants been disclosed in its earlier financial statements. A portion of the disclosure found in Carmike Cinema's 2000 10K is below:

> Management believes that Carmike will be in compliance with the amended covenants during 2000, but there can be no assurance that Carmike will achieve such compliance. Carmike's failure to comply with these financial covenants could result in an event of default which, if not cured or waived, would have a material adverse effect on us.

When this disclosure was released, the initial covenant violation had already occurred and the debt had been amended. It can be inferred from the disclosure notes that the company may have already been heading toward economic failure. Thus, it was too late for investors to use this information to make intelligent decisions about investment in the company. The disclosure also only makes public a few of the requirements under covenant. Investors have no way of trying to calculate the probability of Carmike Cinemas actually violating the amended covenant since the essential ratios to monitor remain unidentified. This disclosure note, which is in accordance with GAAP, merely serves as an admission to the financial volatility of the corporation. Had the investors and analysts known the vital conditions of the debt, they might have been better able to make decisions about the going-concern of the corporation and whether to invest. Thus, Carmike's filing for Chapter 11 bankruptcy-court protection might not have been such a shock to so many.

If knowledge about a corporation's debt covenants is useful information for investor's decision-making, which I believe it is, it is the FASB's responsibility to issue a statement expressly requiring corporations to include the terms of their material debt covenants in the liability disclosure notes on their financial statements.