Client Alert | Banking / Capital Markets

IFRS 16: Are you ready?

European Leveraged Finance Alert Series: Issue 8, 2018

November 2018

Authors: Gareth Eagles, Emma Foster, Rizwan Latif, Amitaben Patel

On 13 January 2016, the International Accounting Standards Board (IASB) announced IFRS 16, a new accounting standard relating to the accounting treatment of leases. In short, the new standard requires lessees to recognise certain operating leases on their balance sheet, contrary to the previous off-balance sheet model. Given its significant impact, parties were urged to consider the impact of the new standards on their loan documentation. After a lengthy transition period, IFRS 16 will take effect on 1 January 2019. This article seeks to remind readers of the impact of IFRS 16, particularly in the context of loan agreements. However, more fundamentally, we will also explore how parties have (or have not, as the case may be) used the last three years to prepare for the change.

Background

From 1 January 2019, IFRS 16 will replace the current arrangement under IAS 17, which treats finance leases and operating leases differently. Under IAS 17, finance leases are treated as debt, such that the 'purchase price' for the lease is noted as a liability on the balance sheet of the purchasing company and the leased asset is noted as an asset (and depreciates over time). Conversely, operating leases remain off-balance sheet, with lease payments charged to the lessee's income statement as an operating expense. Accordingly, it is common for operating leases not to be taken into account when calculating the financial indebtedness of a company, as such amount is derived from its balance sheet position.

IFRS 16 seeks to remove this distinction and treat all leases the same for the purposes of lessee accounting; a shift in line with the general trend being adopted globally. Consequentially, all references to "operating lease" and "finance lease" for this purpose will become obsolete. Companies operating in the retail, transport and telecommunications sectors are expected to suffer the most following the change, as these typically rely heavily on property and equipment hires through leases. However, every company that draws this distinction will be impacted by the change, to a lesser or greater extent.

The above is a high-level summary only and readers should be aware that certain exceptions exist, for example, leases with a term of less than 12 months or in respect of 'low value' assets, which may receive treatment akin to an "operating lease" under the IAS 17 regime.

Impact on Loan Documentation

Whilst the above highlights the main accounting implications of the convergence of accounting treatment, below we consider the consequential impact on certain key facilities agreement provisions. For the purposes of the below and each other instance in this article, we are assuming that the relevant facilities agreement definition will now take account of operating leases as debt in all cases:

Financial covenants:

In most cases, facilities agreements take into account finance leases as part of the "Financial Indebtedness" and "Borrowings" definition, disregarding operating leases. Broadly speaking, with operating leases moving onto the balance sheet, any amounts payable under the leasing arrangements (whether these are considered operating or finance leases under IAS 17) will constitute debt, which in turn will increase the "Financial Indebtedness," as well as "Borrowings" and/or "Total Debt" figures for the purposes of financial covenant testing. Equally, "Finance Charge" figures are expected to be higher in recognition of the interest component of the leases. On the other side of the leverage, fixed charge cover and interest cover ratios, "EBITDA" numbers are also expected to be higher (although not by a corresponding amount to the increase in debt quantum), as EBIT (or operating profits), being the starting point of the "EBITDA" definition in facilities agreements, will no longer be reduced by the lease payment due under operating leases. The popularity of 'covenant-lite' and 'covenant-loose' structures will generally lessen this impact; however, if financial covenants are included in loan documentation, it is still advisable for borrowers and lenders to check if the borrower group is in compliance with their financial covenants and obtaining the benefit of any agreed headroom;

Undertakings and events of default:

Facilities agreements will contain a restriction on the incurrence of "Financial Indebtedness," which may be (i) in the form of an agreed cap (which could be significantly depleted by the inclusion of operating leases); (ii) a grower basket based on "EBITDA" (the size of which will increase on the basis of the discussions above) or assets (again expected to increase as operating leases will now also constitute a company's assets); or (iii) based on an agreed financial ratio (which again, will be impacted per the discussions above). Likewise, the ability to make restricted payments and/or make acquisitions is often also tied to such thresholds or agreed ratios. Similarly, as a result of the increase in "Financial Indebtedness," borrowers should consider whether any *de minimis* agreed as part of the cross-default and certain other events of default need to be increased to prevent inadvertent breach. Lenders and borrowers should consider whether the impact of IFRS 16 will affect the commercial agreement on these points and whether such thresholds need to be revisited; and

Guarantor coverage:

Facilities agreements usually contain a guarantor coverage test, based on assets and "EBITDA" (although increasingly based solely on "EBITDA"). With asset and "EBITDA" numbers inflated by the impact of IFRS 16, it may be easier for borrowers to meet the agreed thresholds. Lenders may wish to consider whether it would be preferable to increase such threshold or use a different compliance metric, potentially a reason to reprise the turnover-based guarantor coverage test.

Current Market Approach

Given the adverse consequences that IFRS 16 could have for both borrowers and lenders under facilities agreements, on 14 June 2016, the LMA updated its recommended form of facilities agreement to provide an optional change to the definition of Finance Leases. The effect of this change is to preserve the pre-IFRS 16 position (namely, commercially retaining the distinction between operating and finance leases). Whilst the language is optional and aimed primarily at deals signed prior to the IFRS 16 effective date, the language is being universally adopted. In fact, in most top-tier sponsor deals, it is usual for additional language to be included in the construction clause of facilities agreements preserving the IAS 17 position.

Additionally, it is usual for borrowers and lenders to agree that Frozen GAAP shall apply, which again preserves the pre-IFRS 16 position. Frozen GAAP allows a borrower to deliver its financial statements and report on compliance with any financial covenants and guarantor coverage test using the same accounting principles, practices and policies it used for the preparation of its original financial statements. Implementation of Frozen GAAP can be by means of production of two sets of accounts (one for the purposes of compliance with accounting standards and one for the purposes of compliance with the facilities agreement); however, the more common approach is for the borrower's auditors to provide a reconciliation statement alongside the company's latest accounts, such that the accounts are based on IFRS 16, but the reconciliation statement shows the position under IAS 17.

What Does The Future Hold?

Interestingly, the current market approach shows a general reluctance by both borrowers and lenders to accept the new accounting standards; parties instead appearing to have utilised the options available to preserve the status quo. However, whilst relying on Frozen GAAP is viable in the short-term, it does not provide a long-term solution. Firstly, not only is the production of two sets of accounts (or providing a reconciliation statement) expensive for companies, it can also be time-consuming; companies will be required to maintain both accounting systems and then analyse both sets of data to produce the relevant deliverables. Separately, once IFRS 16 is effective, borrowers and lenders signing new loan documentation would need to agree to use original financial statements and produce a base case model based on a previous accounting standard, which seems illogical. Ultimately, Frozen GAAP is intended to be a temporary solution, drafting usually anticipating that borrowers and lenders will enter into good faith negotiations to amend facilities agreements as required.

Accordingly, rather than treating IFRS 16 as the elephant in the room, it would be advisable for borrowers and lenders, particularly for new transactions, to embrace IFRS 16 in original financial statements and the related base case models, with financial covenants, thresholds, baskets and ratios being adjusted accordingly. Likewise for existing deals, borrowers and lenders should use the opportunity to consider whether covenants and relevant thresholds should be reset so that borrowers can submit financial statements based on the new accounting standards, rather than relying on Frozen GAAP.

With the supply-demand imbalance currently favouring sponsors, some have questioned why sponsors are not aggressively canvassing for loan documentation to be updated to reflect IFRS 16. Some have suggested that the limited adverse consequences for sponsors and borrowers in maintaining the status quo is the reason for this: a number of facilities agreements contain senior leverage financial ratios only and therefore other forms of financial indebtedness are not taken into account, reducing the likelihood of a financial covenant breach. On the other hand, lenders may also be concerned with making the switchover, with suggestions from some debt analysts that the new standards create opportunity for manipulation by borrowers. Borrowers could, for example, use their commercial bargaining power to obtain leases of terms of less than 12 months (and therefore take advantage of the short-term lease exemption) or, alternatively, ensure substitutability of the asset or restrictions on its ability to exercise control (such that the arrangement does not constitute a lease for the purposes of the new standard).

Notwithstanding these concerns and the reluctance from most market participants to adopt the new standards, some market participants may see a smooth transition over to IFRS 16. Those with significant operating leases may have been using EBITDAR (the “R” representing “before rental expenses”) rather than EBITDA. Such parties will see a position similar to that to be enjoyed under IFRS 16, as contrary to the IAS 17 position (whereby the operating lease payment reduces the EBITDA figure, as this amounted to operating expenses), this already negates the rental impact of assets and therefore assists in reducing the impact of operating leases coming onto balance sheets. For most borrowers, however, this will not be the adopted metric and parties will still be expected to grapple with (and ultimately accept) the accounting standard change. Interestingly, however, some advocates for change have suggested that merely accepting the position is not enough, and instead, IFRS 16 should be viewed as the much-needed catalyst to instigate even further change in the market. One such change may be to move away from using EBITDA as a key performance indicator altogether, on the basis that the test is purely subjective (being a number derived from financial statements by a borrower rather than a clear line item); an argument compounded by increasing discussions and concern with respect to add-backs to EBITDA as part of facilities agreement negotiations. Instead, some have suggested that cashflow or operating cashflow be used as the preferred testing measure as these can potentially be less easily manipulated. Only time will tell if these are viable options.

Conclusion

Parties are advised to familiarise themselves with IFRS 16 and look to implement the standards into their facilities agreement ahead of the upcoming effective date. It is surprising to see such reluctance amongst market participants to accept the new accounting standards, with parties instead focussed on preserving their current arrangements. At the other end of the spectrum, some market participants are pushing for significant changes in market dynamics through suggesting new performance measures. It is unclear how the market will react to this. What is clear, however, is that despite the extensive implementation period, the market is still not ready for IFRS 16, and time is nearly up.

EMEA leveraged finance partners

David Becker ●
Partner, London
T +44 20 7532 1405
E dbecker@whitecase.com

Paul Clews ●
Partner, London
T +44 20 7532 1436
E paul.clews@whitecase.com

Jill Concannon ●
Partner, London
T +44 20 7532 1534
E jconcannon@whitecase.com

Lee Cullinane ■
Partner, London
T +44 20 7532 1409
E lcullinane@whitecase.com

Chris Czarnocki ■
Partner, London
T +44 20 7532 1201
E cczarnocki@whitecase.com

Jeremy Duffy ■
Partner, London
T +44 20 7532 1237
E jduffy@whitecase.com

Gareth Eagles ■ ●
Partner, London
T +44 20 7532 1251
E geagles@whitecase.com

Jacqueline Evans ■
Partner, London
T +44 20 7532 1404
E jevans@whitecase.com

Martin Forbes ■
Partner, London
T +44 20 7532 1229
E martin.forbes@whitecase.com

Emma Foster ■
Partner, London
T +44 20 7532 1299
E efoster@whitecase.com

James Greene ■ ●
Partner, London
T +44 20 7532 1439
E jgreene@whitecase.com

James Hardy ■
Partner, London
T +44 20 7532 2728
E james.hardy@whitecase.com

Colin Harley ■
Partner, London
T +44 20 7532 1200
E colin.harley@whitecase.com

Rob Mathews ●
Partner, London
T +44 20 7532 1429
E rmathews@whitecase.com

Shane McDonald ■
Partner, London
T + 44 20 7532 2698
E shane.mcdonald@whitecase.com

Jeffrey Rubinoff ■
Partner, London
T +44 20 7532 2514
E jeffrey.rubinoff@whitecase.com

Justin Wagstaff ●
Partner, London
T +1 212 819 2694
E jwagstaff@whitecase.com

Ben Wilkinson ■
Partner, London
T +44 20 7532 1276
E ben.wilkinson@whitecase.com

Thierry Bosly
Partner, Brussels
T +32 2 2392 509
E tbosly@whitecase.com

Hadrien Servais ●
Local Partner, Brussels
T +32 2 2392 544
E hadrien.servais@whitecase.com

Claire Matheson Kirton ■
Partner, Dubai
T +971 4 381 6218
E cmathesonkirton@whitecase.com

Rebecca Emory ●
Partner, Frankfurt
T +49 69 29994 1432
E rebecca.emory@whitecase.com

Thomas Flatten
Partner, Frankfurt
T +49 69 29994 1233
E tflatten@whitecase.com

Gilles Teerlinck ■ ●
Partner, London
T +44 20 7532 2232
E gilles.teerlinck@whitecase.com

Florian Degenhardt
Partner, Hamburg
T +49 40 35005 298
E fdegenhardt@whitecase.com

Vanessa Schuermann ■
Partner, Frankfurt
T +49 69 29994 1431
E vanessa.schuermann@whitecase.com

Gernot Wagner ●
Partner, Frankfurt
T +49 69 29994 1430
E gernot.wagner@whitecase.com

Tanja Törnkvist
Partner, Helsinki
T +358 9 228 64 351
E ttornkvist@whitecase.com

Güniz Gökçe
Partner, Istanbul
T +90 212 355 1311
E guniz.gokce@gkcpartners.com

Yoko Takagi
Partner, Madrid
T +34 91 7876 320
E yoko.takagi@whitecase.com

Iacopo Canino
Partner, Milan
T +39 02 00688 340
E icanino@whitecase.com

Gianluca Fanti
Partner, Milan
T +39 02 00688 390
E gianluca.fanti@whitecase.com

Michael Immordino ●
Partner, London
T +44 20 7532 1399
E mimmordino@whitecase.com

Alessandro Nolet ■
Partner, Milan
T +39 02 0068 8420
E alessandro.nolet@whitecase.com

Natalia Nikitina
Partner, Moscow
T +7 495 787 3027
E nnikitina@whitecase.com

Samir Berlat
Partner, Paris
T +33 1 5504 1551
E samir.berlat@whitecase.com

Colin Chang ●
Partner, Paris
T +33 1 5504 5815
E cchang@whitecase.com

Denise Diallo ●
Partner, Paris
T +33 1 5504 1518
E ddiallo@whitecase.com

Raphaël Richard
Partner, Paris
T +33 1 5504 1538
E rrichard@whitecase.com

Jan Linda
Partner, Prague
T +420 255 771 271
E jlinda@whitecase.com

David Plch
Partner, Prague
T +420 255 771 298
E dplch@whitecase.com

Jonathan Weinberg ■
Partner, Prague
T +420 255 771 262
E jweinberg@whitecase.com

Oscar Liljeson
Partner, Stockholm
T +46 8 50632 379
E oscar.liljeson@whitecase.com

Carl Hugo Parment
Partner, Stockholm
T +46 8 50632 341
E carlhugo.parment@whitecase.com

Magnus Wennerhorn
Partner, Stockholm
T +46 8 50632 370
E
magnus.wennerhorn@whitecase.com

Nicholas Coddington ■
Local Partner, Warsaw
T +48 22 5050 160
E ncoddington@whitecase.com

Tomasz Ostrowski ■
Partner, Warsaw
T +48 22 5050 123
E tostrowski@whitecase.com

■ English Qualified ● US Qualified

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, companies and entities.

This publication is prepared for the general information of our clients and other interested person s. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.