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New accounting standard, IFRS 16 Leases — impact on facility agreements

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On 13 January 2016, the International Accounting Standards Board (IASB) published a new accounting standard relating to the accounting treatment of leases—IFRS 16 Leases. The new accounting standard will take effect from 1 January 2019[1].

The IASB is seeking to ensure greater transparency in financial reporting under GAAP and IFRS. The new accounting standard will require lessees to recognise assets and liabilities for all identified leases (including so-called operating leases) of more than 12 months[2] on their balance sheets. For many entities, the amount of newly recognised lease liabilities is expected to be significant.

The IASB and the US Financial Accounting Standards Board worked together on IFRS 16 Leases (and like changes to US GAAP) with a view to converging the accounting treatment for leases under IFRS and US GAAP, principally by agreeing that operating leases should be reflected on the lessee's balance sheet. However, there are some differences under the two reporting regimes that will affect the presentation of leases in the financial statements. For example, under US GAAP, leases that have always been reported on balance sheet will continue to be reported separately from leases that are to be reported on balance sheet as a result of the changes, whereas IFRS will not provide for such a distinction. This article considers the impact on financial covenants from the IASB treatment of leases under IFRS 16 Leases.

In considering the changes, the IASB and the US Financial Accounting Standards Board ran a lengthy consultation process. It was noted that the loan documentation terms for many current deals will not address these changes. Borrowers and their lenders will need to consider the effect of IFRS 16 Leases on the calculations to be made under their facility agreements, in particular on any financial covenants or restrictions relating to the incurrence of financial indebtedness contained in such agreements.

What changes does IFRS 16 Leases bring and why do these matter to lenders?

IFRS 16 Leases will impact any company that currently accounts for any of its leases as "operating leases". Industries where operating leases are used extensively (e.g., retailers, hoteliers, aircraft and shipping) will be most affected, but the effect of the new accounting standard will not be limited to lessees operating in those areas.

IFRS 16 Leases will replace the current arrangement under IAS 17, where finance leases and operating leases are treated separately and with different results. Under the current rules, operating leases remain off balance sheet with lease payments being charged to the lessee's profit and loss account (P&L) as an operating expense. Consequently, it has not been uncommon practice for borrowers and lenders to exclude

[1] IFRS 16 Leases can be adopted earlier if IFRS 15 Revenue from Contracts with Customers is also applied.

[2] IFRS 16 Leases has an exemption for leases of low-value assets.

operating leases when considering the “debt” of a company (e.g., when testing the debt-incurrence or financial-covenant limits under facility agreements). Conversely, finance and capital leases are recognised on balance sheet and have therefore typically been included as “debt” when considering such limits.

IFRS 16 Leases will abolish this dual system and implement a consistent treatment for all leases, with the individual factors of the lease terms (rather than its broad characterisation) being the primary driver for accounting treatment. Each lease will need to be considered individually and factors such as discount rates, the period of the lease and lease payments, and residual-value guarantees or penalties, will all play a part in determining the value and the accounting treatment of any particular lease. However, as a general rule, the following will apply:

(i) the right to use the asset underlying the lease will appear on the lessee’s balance sheet as an asset, with the value of the asset depreciating over time as the lease term expires;

(ii) the present value of future payments will appear on the lessee’s balance sheet as a liability; this will also reduce over time as amortising payments are made (but not necessarily at the same rate that the lease asset depreciates);

(iii) the interest element of the lease will be charged to the lessee’s 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 lessee’s P&L over the life of the lease equal to the annual depreciation in the asset value referred to at (i) above.

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

The treatment of leases under existing facility agreements that have been structured to reflect the accounting treatment used by the borrower under IAS 17 may therefore diverge from the company’s accounting practice post implementation of the new accounting standard. In particular, facility agreements based on the LMA’s current form loan agreement for leveraged acquisition financings (and, indeed, prior versions as well) may be impacted as this form uses a concept of “Finance Lease” in its characterisation of “Financial Indebtedness” and calculations of “Total Net Debt” and “Debt Service” and “Finance Charges”, being any lease or hire purchase contract which would, in accordance with the applicable accounting principles, be treated as a finance or capital lease. Careful consideration will need to be given to how each facility agreement deals with changes that are made to the accounting principles during the life of the facility and whether it facilitates adjustments to ensure consistent treatment.

In cases where a facility agreement generally excludes so-called operating leases from its treatment of “debt”, borrowers and lenders should consider the impact of a convergence of accounting treatment for all leases. Among other things, the following aspects of the borrower’s operations and condition that are typically regulated by lenders may need to be reconsidered or adjusted:

- the borrower’s financial condition, the financial covenant calculations, and various loan metrics based on the borrower’s financial condition (e.g., in leveraged-based margin calculations or incurrence, acquisition, and restricted-payment tests);
- the financial indebtedness of the borrower and the restrictive covenant terms (e.g., both the debt incurrence covenant, generally, and the scope of permitted finance lease baskets, specifically); and
- the financial indebtedness of the borrower and the scope of the cross-default provision.

The Borrower’s financial condition

In the context of loan documentation, a borrower’s financial condition is typically assessed by reference to its accounting performance, subject to some targeted adjustments. One relevant consideration will therefore be whether the borrower is required to deliver its financial statements and report on its financial covenant performance using:

- “frozen GAAP”, i.e., using the same accounting principles, practices, and policies from the preparation of its original financial statements or any original base case model; or

- "floating GAAP", i.e., taking into account the changes in GAAP from time to time.

It is common for frozen GAAP to be adopted in leveraged-finance transactions. (Among other things, it helps to facilitate like-for-like comparisons over the loan period.) However, even when a facility agreement generally requires ongoing adherence to the original accounting methodology it may also contain provisions designed to help the parties deal with any changes that are made to the borrower's underlying accounting principles over the life of the facility. The manner in which these play out can differ from deal to deal.

For instance, such arrangements usually require the borrower's auditors to provide a reconciliation statement so that the lenders can determine whether the financial covenants have been met on the basis on which they were set. But they may also require the parties to enter into consultation about making appropriate adjustments to the loan documentation, or indeed, contain a dispute-resolution mechanic involving reference to an independent third party specialist.

Even when the terms of a facility agreement specify the process to address such changes (or are based on floating GAAP), the parties may disagree on the way in which the changes to the accounting practices should be reflected or how they impact the various defined terms used in the facility agreement. Parties may even disagree on how the different elements of operating leases (including rental, interest, and other payments) should now be treated.

A high-level summary of some potential effects of the change on the financial covenants is summarised in the table below and analysed in more detail in the Annex to this note.

Covenant	Relevant defined term	Effect if all leases are caught	Effect if no leases are caught
Leverage	Total Debt EBITDA	Increase Increase	Decrease Increase
Interest Cover	Finance Charges EBITDA	Increase Increase	Decrease Increase
Cashflow Cover	Debt Service Cashflow	Increase Increase	Decrease Increase

The Financial Indebtedness of the borrower

As mentioned above, the current accounting concepts of finance and capital leases are commonly used to determine which leases constitute "Financial Indebtedness". However loan documents are typically silent on how "Financial Indebtedness" should be determined if these accounting concepts are abolished. Questions of contractual interpretation may therefore also arise on this point.

Following the implementation of IFRS 16 Leases and the general shift to treat all leases more closely in line with the current treatment for finance leases (i.e., on balance sheet), lenders might argue that any reference in financial definitions to "finance lease" should not only continue to cover leases that used to be covered by such a characterisation but also extend to include any and all leases. Conversely, although seemingly somewhat more extreme in its result, borrowers might assert that the intentions of the standards boards in implementing IFRS 16 Leases (especially for contracts agreed before 2016) are irrelevant, the abolition of the accounting concept has left the loan agreement definition empty, and that no leases should be included.

There is a long line of cases where the courts have had to strike a balance between the wording of the document and competing interpretations. From time to time court judgments emphasise different aspects of this task. First and foremost we know that the courts would look at the words of the contract and the language involved. But, depending on the facts involved, the kinds of things a court might also consider could include: what it ascertains to be the objective intention of the parties; business common sense; the commercial purpose of the contract; and issues of reasonableness. It remains to be seen how a court would approach the terms of any given facility agreement, or indeed whether it would distinguish between (i) contracts formed before IFRS 16 Leases was published and (ii) those that parties, knowing that the accounting concept was set to be abolished, nonetheless still entered into using the accounting terminology without provision for its pending abolition. All in all, it would likely be a very fact-specific process on a case-by-case basis.

Could IFRS 16 Leases trigger a breach of a facility agreement?

If we assume that the relevant definitions are interpreted to include all leases, the "financial indebtedness" of a borrower with operating leases would increase as a result of IFRS 16 Leases. Similarly the scope of the cross-default provision would be extended. In both senses the possibility of a default would increase due to the change. This risk may be significant for borrowers that rely heavily on operating leases.

What was the consultation process for IFRS 16 Leases?

IFRS 16 Leases was issued following a long consultation process by both the IASB and the US Financial Accounting Standards Board. A public survey was also conducted in July 2015 by the IASB together with the European Financial Reporting Advisory Group, the Financial Reporting Council and the National Standard Setters of France, Germany, Italy, Lithuania and the UK to assess how the new standard would impact financial covenants in facility agreements in practice. The Feedback Report[3] for the survey found that the facility agreements of a large majority of lenders that responded included automatic renegotiation clauses in the case of a change to accounting principles, "frozen GAAP" provisions or adjustments for operating-lease commitments in determining covenants. The Feedback Report states that for facility agreements containing these features the requirements of IFRS 16 Leases are not expected, in isolation, to cause a breach of covenants.

Conclusion

Parties will be well advised to prepare for IFRS 16 Leases 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

Lenders and borrowers will need to review their facility agreements to ascertain whether the new changes to the accounting treatment of leases will result in leases that have previously been ignored for the purposes of any financial indebtedness restrictions 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 facility agreements provide for floating GAAP there is clearly a potential issue and a possible need for amendment, waiver or covenant adjustments to be effected to take account of the changes; and

(ii) where facility agreements provide for frozen GAAP, although there may not be an immediate impact, it may be unclear whether any "financial indebtedness" definitions are "frozen" and even where both financial indebtedness and the financial covenants are "frozen". The delivery of reconciliation statements may address lender concerns in the short term, but would require the borrower to maintain two sets of accounts and is therefore not likely to be viable over a longer period.

Ultimately, parties should begin to think about whether the current accounting principles should continue to be used for loan documentation purposes until maturity to facilitate ongoing like-for-like comparisons to earlier performance and to maintain the basis on which the covenant ratio levels, margin leverage levels, and other thresholds were originally set (notwithstanding the split this might create from the borrower's accounting obligations and reporting) or if the new regime should be adopted and corresponding adjustments made to such levels and thresholds.

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[3] *IFRS 16 Leases: Consultation on the impact on financial covenants in loan agreements* (*December 2015*)

New deals

Lenders and borrowers entering into new or amended facility agreements should take account of the potential impacts outlined above 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.

One option would be to include an express carve-out of any operating leases which have been re-characterised and brought onto the balance sheet by changes to the applicable accounting principles (whether as a separate clause or within the definition of "Finance Lease"). Or alternatively, include a clause stating that only finance or capital leases that would be captured as a "Finance Lease" as at the date of the agreement are to be included as such, notwithstanding any changes to the applicable accounting principles. These changes reinforce the frozen GAAP position and remove any uncertainty but would not alleviate the need for the delivery of reconciliation statements.

Annex A

Further analysis of the change on the financial definitions and covenants

	Current treatment	IFRS 16 Leases
Borrowings **Financial Indebtedness** **Total Debt**	Only include the aggregate capital (or principal) element of payments under "any lease or hire purchase contract which would, in accordance with the applicable accounting principles, be treated as a finance or capital lease"[4] Amounts payable in respect of operating leases are not treated as Financial Indebtedness (or Total Debt) for general or financial covenant purposes	Any amount payable under any lease (including leases that are currently classified as "operating leases") that is accounted for as a liability on the balance sheet would typically fall to be treated as Financial Indebtedness (or Total Debt) for general or financial covenant purposes This would include the present value of future capital payments for all leases
Cashflow	Cashflow is derived from EBITDA which (as per below) is reduced by rental payment amounts on operating leases An adjustment is made, however, in case of changes to Working Capital (being Current Assets less Current Liabilities). As current rental payments are recognised as Current Liabilities, a change in the aggregate rental payment amount from Relevant Period to Relevant Period that effects a change in Working Capital would increase (in the case of a decrease in Working Capital) or reduce (in the case of an increase in Working Capital) Cashflow	As EBITDA would no longer be adjusted by the rental payment deduction, Cashflow would also increase Current Liabilities exclude liabilities for Finance Charges. If what are currently recognised as rental payments for operating leases are re-characterised as Finance Charges, changes to the aggregate amount of such payments would no longer result in a change in Working Capital and a corresponding adjustment to Cashflow. However, the initial re-characterisation itself could see a change in Working Capital in respect of any then-existing operating leases. This would need to be recognised (e.g., Cashflow would reduce as a result a decrease in Current Liabilities increasing Working Capital)
Debt Service	As per Finance Charges, below	As per Finance Charges, below
EBITDA Used in the leverage and interest-cover ratios and as the starting point for determining Cashflow in the cashflow-cover ratio	The rental payments on operating leases are deductible as a general operating expense of the company	These rental payments will no longer be recognised as deductible operating expenses and may, rather, fall to be recognised as interest-like expenses. EBITDA will therefore increase (The related concept of EBIT could also see a reduction to the extent of any new depreciation charge arising in connection with the value of the lease asset on the company's balance sheet; however this will not track through to EBITDA, which is *before amortisation*)
Finance Charges Used in the interest cover ratio and as the starting point for determining Debt Service in the cashflow-cover ratio	Finance Charges include the interest element of payments in respect of "Finance Leases", only Rental payments in respect of operating leases are typically excluded	The interest component of all leases could be recognised as a "Finance Charge"

4 LMA, Financial Covenants.

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