SLAUGHTER AND MAY

Update for Corporate Treasurers

# Freeze! IFRS 16 has been finalised

**Significant changes to lease accounting rules have been on the IASB's agenda for many years. New IFRS 16 was finally published in January. Major accounting changes will often have an impact on financial definitions and ratios used in loan and other finance documentation. This article outlines some of the key aspects of LMA-based loan documentation that are likely to be affected by the new approach to leases, how those changes are being anticipated in practice and the LMA's response.**

## What is changing and when?

Treasurers will be well aware that leases may be accounted for in different ways under current rules. Under IAS 17, the accounting treatment depends on the underlying economic effect of the lease. If the arrangement amounts to the financial equivalent of an asset purchase (because it "transfers substantially all the risks and rewards of ownership of an asset to the lessee"), the lease is classified as a finance lease. Any lease that is not a finance lease, is an operating lease.

Finance leases, are essentially treated as debt. In the lessee's accounts, the leased asset appears on the asset side of the balance sheet and a discounted amount in respect of the obligation to pay rent will appear as a liability, as if the lessee had bought the asset and incurred debt to pay for it. Assets leased under an operating lease, in contrast, do not appear on the balance sheet. Rental payments in respect of operating leases are currently charged to the income statement as operating expenses.

IFRS 16 represents a major alteration in the approach to lessee accounting[1]. The key point for present purposes is that under IFRS 16, most leases – including leases that are currently classified as operating leases – must be accounted for on-balance sheet. As the standard is adopted, lessee companies' balance sheet assets and liabilities will increase, in some cases, quite significantly. The change will also impact the income statement, as the charge for depreciation and interest expense that currently applies only to finance leases, will apply to all on-balance sheet leases.

Companies are required to adopt IFRS 16 for accounting periods starting on or after 1 January 2019, although earlier adoption is permitted subject to conditions.

[1] IFRS 16 does not substantially change the IAS 17 accounting regime as applicable to lessors. The commentary in this note is focussed on its impact on lessees.

## How will the adoption of IFRS 16 impact loan documentation?

The balance sheet-recognition of operating lease commitments has the potential to affect a number of financial tests and ratios used in loan documentation:

- Loan terms that reference the lessee group's total assets, for example, asset-based financial ratios and guarantor coverage tests, as lessees' gross or total assets will increase.
- Measures of profitability such as EBITDA, which are commonly used in financial ratios and other tests, due to the increase in charges for depreciation and interest expenses.
- Provisions which purport to measure indebtedness, as loan market practice is to treat only finance lease obligations as borrowings, in line with the current accounting treatment.

The impact of IFRS 16 on provisions which measure indebtedness has been an area of particular focus. The LMA definition of "Financial Indebtedness", which typically frames the scope of any covenant restricting the incurrence of indebtedness, as well as the cross-default Event of Default (and potentially also, aspects of the negative pledge) captures liabilities under "Finance Leases" only. Similarly, the LMA definition of "Borrowings" in current usage, which typically determines the debt components of various financial covenants, for example, leverage, interest cover and cashflow cover ratios, includes "Finance Lease", but not operating lease liabilities. A "Finance Lease" is defined in relation to the LMA definitions of "Financial Indebtedness" and "Borrowings" as "any lease or hire purchase contract which would, in accordance with the Accounting Principles, be treated as a finance or capital lease".

IFRS 16 does not dispense entirely with the classification of leases as finance leases and operating leases, but the distinction is retained only for the purposes of lessor accounting. In a lessee's accounts, applying the new standard, leases will not be required to be "treated" as finance or capital leases. How therefore should the current LMA definition of "Finance Lease" and any other definitions that purport specifically to capture finance lease and not operating lease obligations be interpreted once the new standard is adopted?

The application of the normal English law standards of contractual interpretation might support an argument (based on the intentions of the parties at the time the contract was entered into) that provisions in existing loan documentation that reference finance leases should be interpreted so as to capture obligations classified as finance lease obligations under the Accounting Principles as at the date of the agreement. However, the potential for uncertainty means that many borrowers with loan facilities extending beyond the implementation date for IFRS 16 have for some time been choosing to provide expressly that any reference in their documentation to the term "finance lease", shall be interpreted in accordance with the accounting principles applicable as at the date the facility was entered into (often referred to as "frozen GAAP").

## The LMA's response

On 14 June, the LMA updated all of its recommended forms of facility agreement to anticipate the transition to IFRS 16. The LMA's proposal, which was discussed with the ACT prior to publication, is that any reference to a finance or capital lease, should be re-cast to refer to:

> *"…any lease, which would, in accordance with applicable GAAP, be treated as a balance sheet liability [(other than any liability in respect of a lease or hire purchase contract which would, in accordance with GAAP in force [prior to 1 January 2019]/[prior to [ ]]/[ ], have been treated as an operating lease)]..."*

This revised definition applies for the purposes of the definition of "Financial Indebtedness" and in the definition of "Borrowings" that is used in financial covenant calculations.

The removal of any reference to the term "finance lease" is useful to address the interpretative difficulties that will arise once that term has no meaning in the context of lessee accounts. The optional language in square brackets is, in effect a "frozen GAAP" provision. Footnotes highlight that the appropriate drafting here is to be negotiated, taking into account whether the agreement is being negotiated before or after IFRS 16 comes into force and indeed whether IFRS 16 is the applicable accounting standard (the lease accounting standards under US and other domestic GAAP regimes are also changing).

For loan agreements being entered into prior to 1 January 2019, treasurers may feel slightly uncomfortable defining lease obligations that are to be counted as financial debt in accordance with "GAAP in force prior to" a future date (eg 1 January 2019). It seems unlikely based on current information that further changes would be made to the accounting treatment of leases prior to 1 January 2019, but it is theoretically possible. In addition, some companies may adopt IFRS 16 at an earlier date if the relevant conditions specified in the standard are satisfied.

Accordingly, where "frozen GAAP" is the preferred position, it is suggested that the following option (referred to in the footnotes to the LMA drafting) is preferable for the time being:

> *"…any lease, which would, in accordance with GAAP in force as at the date of this agreement, be treated as a balance sheet liability…".*

## Reporting obligations

The use of "frozen GAAP" language should ensure that the contractual terms are interpreted in a manner that will not result in a technical covenant breach. However, the related and perhaps more important question is, once the borrower becomes obliged to prepare its financial statements in accordance with IFRS 16, how the borrower is to illustrate to the lenders that any financial covenant provisions have been complied with.

The LMA recommended forms of facility agreement contain an optional, but commonly adopted provision which requires that each set of financial statements delivered pursuant to the agreement is prepared on a basis consistent with the first. If there is a change in accounting standards or policies, the borrower is required to notify the agent and provide information sufficient to enable the lenders to compare the most recently delivered financial statements with the original set and to determine whether the financial covenants (to the extent applicable) have been complied with.

This provision is a useful transitional arrangement, although not broad enough to reverse the effects of the proposed new lease accounting standard on provisions other than any financial covenant tests, for example, the definition of "Financial Indebtedness". It should therefore ideally be adopted in conjunction with a "frozen GAAP" definition of "Finance Leases" for all purposes, as described above.

Even for financial covenants, however, it is not a long term solution as it requires the borrower to produce two sets of accounts, which is unlikely to be practical on an ongoing basis.

## Anticipating amendments

If the intention of the lending community is to capture all on-balance sheet leases within financial measures and ratios in loan documentation going forward (or indeed, if it is concluded that all leases should be excluded from such measures and ratios), covenant tests and baskets will need to be re-set to accommodate IFRS 16. A covenant re-set may be also be the preferred option for borrowers, due to the practical difficulties of maintaining frozen GAAP.

Many companies have yet to digest the full implications of the transition to IFRS 16 on their financial statements. For companies with extensive operating lease commitments, the impact may be significant, and for some, a reassessment of their lease commitments on a structural level may ensue. This process will need to be completed before any related amendments can be made to a company's loan agreements or other financing documentation.

In the meantime, in addition to "freezing GAAP", borrowers embarking on a refinancing may wish to anticipate the need for future amendments, as many did prior to the adoption of compulsory IFRS in 2005. During that period, many lenders and borrowers supplemented the "frozen GAAP" and LMA reporting provisions referred to above with a clause endorsed by the ACT and the LMA, providing that in the event of a change in accounting principles, the parties will enter into good faith negotiations with a view to agreeing any amendments to the agreement necessary as a result of the change, with the aim of ensuring that the change does not result in any material alteration to the commercial effect of the relevant obligations. Such clauses provided a helpful framework for the implementation of IFRS-related covenant amendments and may be of similar assistance in anticipating IFRS 16 and the equivalent changes to US and other local GAAP regimes.

## Going forward

One might question whether the new standard could lead to any more fundamental changes in the way lenders assess the level of debt in a borrower's business in loan documentation going forward. Leverage tests are a key metric for lenders in all sectors of the loan market as well as for certain regulators. It seems reasonably certain that it will become challenging to compare leverage levels across industries following the adoption of IFRS 16, due to differing levels of operating lease commitments. Could this result in changes to how leverage ratios are used and formulated? Will EBITDA definitions be adjusted to address the increase that could result from "old" operating leases moving to the balance sheet (the LMA has added a footnote to its financial covenant provisions to highlight this to lenders as a point to consider)? Until the accounting impact of IFRS 16 has been fully considered and lenders have had the opportunity to assess the impact on the level at which affected financial covenant ratios will need to be set, this remains to be seen.

For further information on any of the issues highlighted, we would encourage you to contact Stephen Powell, Kathrine Meloni, or your usual adviser at Slaughter and May.

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