ARE YOU READY FOR THE NEW LEASE STANDARDS UNDER IFRS 16?

13 December 2018 | Global
Legal Briefings – By **Gabrielle Wong and Ahu Yalgin**

CHANGES IN A NUTSHELL

From 1 January 2019, a new IFRS 16 standard, which was published by the International Accounting Standards Board in January 2016, comes into force. It will profoundly change the accounting treatment of leases by requiring companies to bring most leases on-balance sheet.

The new standard will ensure that the current dual accounting model for lessees, which distinguishes between on-balance sheet finance leases and off-balance sheet operating leases, will be eliminated in favour of a single, on-balance sheet accounting model similar to current finance lease accounting.

HOW WILL THE NEW IFRS 16 IMPACT BALANCE SHEETS OF LESSEES AND THEIR FINANCING ARRANGEMENTS?

Currently under IAS 17 (the predecessor of IFRS 16), rental payments of operating leases are recorded in income statements as operating lease expenses and the leased asset is not reflected on the balance sheet. With the new IFRS 16, the lease becomes an on-balance sheet liability that attracts interest, together with a new asset on the other side of the balance sheet:

- The lease liability will be equal to the discounted present value of the lease payments to be made over the term of the lease.
- The right to use the leased asset is initially measured at the amount of the lease liability and will depreciate over the term of the lease.

As a result, lessees will appear to have become more asset-rich yet, at the same time, more indebted. In practice we are likely to see repercussions with respect to the calculations of total assets, debt, interest expense and EBITDA, and compliance with the related covenant ratios and baskets in financing agreements.

The adoption of IFRS 16 is expected to have a very significant impact on the consolidated income statements and the consolidated balance sheets of companies which are active in industries that have material off-balance sheet lease commitments (e.g. transport industries, retail and wholesale).

Generally companies that have significant exposure to operating leases will observe the following changes to their financial statements as a result of implementing IFRS 16:

- Total assets will increase, as the right to use the leased assets will be reflected on the balance sheet;
- Total liabilities will increase as lease payments will appear on the balance sheet;
- Interest expense will increase, as a portion of the rent expense is recharacterised from an operating expense to interest expense; and
- Depreciation will increase, as a portion of the rent expense is recharacterised from an operating expense to depreciation.

The effect of these changes will impact financial ratios and covenants in current financing agreements, such as cashflow cover (debt service will increase but so will EBITDA given that rental payments are recharacterised from an operating expense to interest expense and depreciation which are added back in calculating EBITDA), interest cover ("Finance Charges" and EBITDA will increase but the net result depends on the relativity), gross asset tests (total assets on the balance sheet will increase so the guarantor coverage test will warrant scrutinising) and borrowing limits ("Financial Indebtedness" typically includes lease liabilities).

For companies with high yield bonds, a number of high yield bond covenants, including the debt covenant (incurrence of which is typically based on 2x fixed charge cover), the restricted payments build-up basket, the liens covenant and the merger covenant (meeting the 2x fixed charge cover) warrant careful consideration, including the following:

- An increase in debt, which will affect leverage ratios;
- An increase in interest expense which will have an effect on the fixed charge coverage ratio in particular;
- An increase in total assets, which will inflate asset-based grower baskets; and
- An increase in EBITDA, impacting, among others, the fixed charge coverage ratio and leverage ratios, as well as EBITDA-based grower baskets.

Therefore, a thorough analysis of financial definitions and financial ratios in all existing financing and capital markets documents is needed to gauge whether amendments may need to be considered for more headroom or in some cases whether there is sudden additional flexibility.

FROZEN IFRS – A BULLET PROOF SOLUTION?

The position that most financing agreements currently adopt in light of the new accounting standards is to include a frozen IFRS concept for operating leases to ensure clarification that if operating leases are subsequently treated differently as a result of any change to the treatment of such leases under the then current accounting principles, the obligations will be treated in accordance with the original accounting principles which were in place when the relevant finance documents were entered into. As a result, "Financial Indebtedness" and "Net Debt" (for calculating leverage) will not be affected and the interest element of rental payments will not count towards "Finance Charges" (which impact interest cover and fixed charge cover ratios). By the same token, any EBITDA increase from IFRS 16 that the borrower will receive post 1 January 2019 will also be made clear not be taken into account.

Overall the frozen concept is still a borrower-friendly position. However, this approach, whilst being the most widely adopted one for the time being, may potentially create distortions between the financial ratios under the relevant financing agreements and the current accounting statements of the companies, resulting in the onerous requirement of provision of reconciliation statements for lenders to make financial calculations at each testing date.

For further information on the impending changes under IFRS 16 and how they may affect your business, please contact Gabrielle Wong or Ahu Yalgin.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

GABRIELLE WONG
PARTNER, FINANCE, LONDON
+44 20 7466 2144
gabrielle.wong@hsf.com

LEGAL NOTICE