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New lease accounting standard IFRS 16 – all change for lessees

Lease accounting is being overhauled for companies accounting under full International Financial Reporting Standards (IFRS), resulting in on-balance sheet treatment for operating leases for the first time. The change will impact most companies using IFRS in some way, but groups operating in sectors with traditionally large operating lease portfolios, such as retail, transport and communications will be particularly affected. This briefing summarises the accounting change and its key impact on English law financing agreements.

Why the change?

"One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet." So spoke Sir David Tweedie (former Chairman of the International Accounting Standards Board (IASB)) in 2008. In 2010, the IASB and the US Financial Accounting Standards Board launched a project to improve lease accounting, by requiring greater transparency of an entity's lease obligations and financial position for investors and analysts. The IASB estimates that in 2014 around 85% of lease liabilities of listed companies using IFRS or US GAAP were off-balance sheet.

This project culminated in January 2016 with the publication of a revised IFRS standard – IFRS16 *Leases*.

What does IFRS 16 do?

Lessees

IFRS 16 introduces a single lessee accounting model which requires all leases (with limited exceptions such as low value asset leases) with a term of over 12 months to be brought onto the balance sheet, including, for the first time, operating leases. It will replace IAS 17, the current IFRS accounting standard for leases.

Timing: The changes will be effective for accounting periods beginning on or after **1 January 2019**. (Earlier application is permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers*).

Lessors

IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, i.e. a lessor will continue to classify its leases as operating leases or finance leases and account for them separately. In other words, lessor accounting will remain substantially unchanged but there will be greater disclosure requirements.

Impact for lessees - accounts

IFRS 16 will change the way in which leases are accounted for in financial statements:

- The Statement of Financial Position (balance sheet) will record every affected lease as:

  (a) a right-of-use asset; and

  (b) a liability (the obligation to make future lease payments).

IFRS reporting entities with substantial operating lease commitments will consequently have a much higher debt figure on their balance sheets.

Key issues

- IFRS 16 will affect the accounts of groups with operating lease liabilities.
- Little change for lessors.
- The changes will come into effect for accounting periods beginning on or after **1 January 2019**.
- Implications for debt and earnings based financial calculations in debt financing documents need to be considered now for existing and new agreements.

- The Income Statement (P&L) will record lease expenses as:
  - (a) a depreciation charge for lease assets; and
  - (b) an interest expense on lease liabilities (included within finance costs). Currently, rental payments for operating leases are presented as operating expenses higher up the P&L.

  These changes may impact the calculation of EBITDA due to the change in interest expense.
- The Cash Flow Statement will look different. Although the total amount of cash flow reported should not change, the presentation of cash flow to the extent it relates to former off-balance sheet leases (i.e., operating leases) will change. Operating cash outflows will reduce with a corresponding increase in financing cash outflows.

The impact on financing agreements

Depending on the drafting of the agreement, IFRS 16 may affect financial definitions and covenants, other debt related covenants and cross-default clauses. The same applies to other agreements which include such provisions, including lease agreements.

In standard financing agreements, definitions such as "Indebtedness for Borrowed Money", "Financial Indebtedness", "Borrowings" "Interest Expense", "Fixed Shares" and "Capital Expenditure" (and their equivalents) include obligations in respect of finance leases. Currently, operating leases do not tend to be treated like a borrowing and so are not usually included in these definitions. It could be argued that once IFRS 16 comes into effect, "finance leases" will include all on-balance sheet leases, including operating leases, as they will be treated like finance leases, resulting in higher levels of these defined categories.

Some of these financial definitions are typically used in cross-default clauses and in negative covenants restricting debt incurrence. Additionally, some are used in financial covenants, such as those which measure gearing, leverage, interest cover and cash flow cover.

Whereas the definitions and related metrics described above will be negatively impacted by IFRS 16 (and potentially breached), it is likely to have a positive (in some cases significant) impact on EBIT and EBITDA, as operating lease payments will no longer sit within operating expenses (which reduce EBIT/EBITDA).

An increase in EBIT/EBITDA will have a positive impact on leverage and interest cover ratios, although it is unlikely that any such increase will balance out any increase in debt.

Existing financing agreements

The extent to which existing deals which use these types of definitions will be affected by the accounting change will depend on a number of factors. For example: the Group's operating lease portfolio; whether allowances have already been made to exclude operating leases in the event of any accounting change; how tightly financial covenants have been set; and whether "frozen GAAP" has been used.

Deals maturing prior to 1 January 2019:

Because IFRS 16 only takes effect for accounting periods beginning on or after 1 January 2019, financings which mature prior to this date will not be affected unless the relevant company elects to implement IFRS 16 early.

Deals maturing on or after 1 January 2019:

Incurrence covenants and cross-default clauses

These could be affected as soon as IFRS 16 comes into force.

Financial covenants

Loan agreements typically deal with changes in accounting standards in one of two ways. The impact of IFRS 16 on financial covenants will depend on which approach is followed.

If the "frozen GAAP" approach is adopted, each set of financial statements must be prepared on the same basis used in the preparation of the "Original Financial Statements". So, an affected Group's auditors would have to produce (a) a description of the changes needed for the new IFRS 16 compliant financial statements to reflect the original accounting standards and (b) information to enable the lenders to ascertain whether the financial covenants have been met.

Although frozen GAAP would prevent the accounting change from triggering a breach of financial covenants, it is generally accepted in the market (investment grade in particular) that using frozen GAAP with reconciling statements is only a short term solution as it requires the production of two different sets of financial statements. Consequently, wording is

sometimes included requiring the parties to enter into negotiations with a view to amending the financial covenants in the event of a change in accounting standards.

Alternatively, "floating GAAP" may be used. This requires accounts to be prepared in accordance with GAAP applicable from time to time, in which case, once IFRS 16 comes into effect, accounts would have to be prepared in accordance with IFRS 16. Although a Group would only have to produce the one set of accounts, its financial covenants would have been set on the basis of the old accounting standards. This would result in different figures, potentially causing a breach of financial covenants in the absence of amendments.

Possible amendments to existing deals:

Obligors may seek to exclude operating lease liabilities from the debt definitions so that debt figures do not increase for financial covenants, other debt based covenants and cross-default clauses.

If an increase in EBIT or EBITDA is likely and significant, amendments may be needed to the definition so that rental payments for pre-IFRS 16 operating leases are added back as an expense after 1 January 2019 (reducing EBIT/EBITDA). Alternatively, ratios could be adjusted after that date to take account of a higher EBIT/EBITDA.

New financing agreements

Parties should consider whether operating leases should be excluded from lease liabilities falling within the debt definitions in readiness for the accounting change. The Loan Market Association's recommended forms of facility agreement have been updated recently with an option to exclude operating lease liabilities from the debt definitions.

Parties should also consider how to address any future increase in EBIT/EBITDA, particularly in deals involving obligors with substantial operating lease portfolios.

Sale and Leaseback

The use of the sale and leaseback (SLB) mechanism to finance assets is likely to decline as a result of the new determination required by IFRS 16 as to whether a sale has occurred (using the definition of a sale in IFRS 15) coupled with the new on-balance sheet treatment of leases.

Currently, SLB accounting focuses on the classification of the "leaseback" element. IFRS 16 focuses on the classification of the initial transfer as a sale. The lessee, as seller, will measure its right-of-use asset based on the portion of rights retained, compared with its carrying amount before the sale. If the purchase price is not equal to the fair value of the asset, the lessee will have to recognise either a lease prepayment or an additional financing amount. If the initial transfer is not classified as a sale, then the lessee will not de-recognise the asset and the purchase price received will be treated as a liability.

Tax Treatment

In many jurisdictions, the accounting treatment of a transaction will be the starting point for working out its tax treatment. However, depending on the jurisdiction in question, the treatment of a transaction under IFRS

Asset finance sector

Airlines and other big-ticket asset operators will be particularly affected by the new rules, given that many of their leased assets are off balance sheet (and the exclusions for low value assets and short term leases are unlikely to apply). The initial recognition of the operator's lease liability (based on the present value of its unpaid lease payments) and its right-of-use asset (based on the lease liability, plus initial direct costs, estimated restoration costs and any prepayments) will result in an increase in the operator's financial liabilities and lease assets at lease commencement. The subsequent measurement of the operator's lease liability (using the effective interest rate method) and a straight-line depreciation of the right-of-use asset under IFRS 16 will result in a "frontloading" of lease expenses earlier in the lease term. The new treatment of sale and leasebacks may also impact on an operator's financing options.

However, while an operator's existing and future corporate facilities may be impacted by the new rules, it should be noted that operators of high-value, long-life assets choose to lease such assets for reasons other than the accounting treatment of such arrangements. Operating lessors and specialised asset financiers offer funding solutions which lessees will continue to consider.

Supplier or financing arrangements which involve the lease of a number of assets and/or the provision of services related to the asset(s), such as maintenance, should be reviewed in light of the requirement under IFRS 16 to identify and account for each lease component separately (subject to an option to elect not to separate lease and non-lease (service) components). For example, so-called "soggy" leases in the rail sector may fall within this requirement.

16 may be modified, or disregarded altogether for tax purposes. Obtaining detailed tax advice will therefore be essential.

SMEs, UK GAAP and US GAAP

IFRS for SMEs

The IASB has stated that lease accounting under IFRS for SMEs (which is based on the existing IAS 17 with the operating/finance lease distinction) is not changing in the near future as the standards were only revised last year. Consequently, groups using IFRS for SMEs will not be affected unless and until IFRS for SMEs is brought into line with IFRS 16.

UK GAAP

A company using FRS 101 (full IFRS but with reduced disclosure) for its individual accounts will be subject to the accounting change. However, there is no change for UK companies using FRS 102 (the so-called "main UK GAAP" which is based on IFRS for SMEs with the operating/finance lease distinction).

Financial Accounting Standards Board (FASB) – US GAAP

The new FASB standard on lease accounting (Accounting Standards Update No. 2016-02) was published in February 2016. The initial objective of a converged IASB and FASB standard on lease accounting has not happened.

For the balance sheet (like IFRS 16) both capital and operating leases will now go on as liabilities. However, US GAAP will retain the distinction between operating and capital leases for the purposes of how lease expenses flow through the P&L.

Power and utilities sector

The changes in the way that leases are defined under IFRS 16 will be of particular interest to companies in the power and utilities sector as some commercial contracts will need to be assessed in accordance with the new rules and may no longer attract off balance sheet treatment.

IFRS 16 defines a lease as a contract, or part of a contract, that conveys to the customer the right to use an asset for a period of time in exchange for consideration. The new guidance as to what arrangements constitute a lease within a contract focuses on whether a customer *controls* the use of the relevant asset, i.e. obtains substantially all of the economic benefits from use of the asset and directs the use of the asset throughout the period of use.

The IASB has provided illustrative examples as part of its guidance on the definition of a lease, including:

- **Fibre-optic cable** – a contract between a utilities company and a customer for the right to use a specified amount of capacity/specified fibres within a fibre-optic cable over an agreed period; and
- **Power purchase agreements** – a contract between a power generator and a customer for the supply of electricity produced by a particular power plant over an agreed period.

In each case, whether the customer controls the use of the asset is a matter of fact based on an analysis of the particular contractual arrangements. The customers in such arrangements will need to assess the implications of the new rules and lessors (e.g. the power generators or utility companies) in some cases may find it more difficult to secure such long-term agreements or see changes to the terms that customers are willing to accept.

Conclusion

IFRS 16 has been a long time in the making. Whilst the on-balance sheet treatment of operating leases comes as no surprise to the markets, businesses will be carrying out data collection and impact assessments to analyse the full effect of IFRS 16 on, among other things, their financial statements and relationships with third parties. Credit providers, lawyers and other advisers will need to be ready to respond.

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