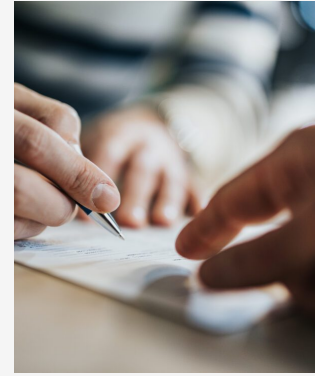


The impact of IFRS 16 on bond and loan covenants — five years out

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A little more than five years ago, IFRS 16 *Leases* took effect and rewrote the accounting rules for classifying leases and lease payments in financial statements for most public companies in Canada. The change added a new layer of complexity to bond and loan covenants that companies and their advisors continue to grapple with a half decade later.

The previous rules for lease accounting (IAS 17) provided a straight-forward approach to the treatment of leases in typical debt covenants. Leases were helpfully split into two categories — capital leases and operating leases. Capital leases were those that transferred substantially all the risks and rewards of ownership to the lessee. They had characteristics similar to an amortizing loan and were accounted for on the balance sheet, with lease payments treated as a mix of interest and depreciation. All other leases fell into the operating lease category and were accounted for as normal course payables and off-balance sheet liabilities. This distinction meant that capital leases were accounted for in debt covenants, and operating leases were outside their scope.

Revisiting the key impacts of IFRS 16

The key change ushered in with IFRS 16 was eliminating the concept of an operating lease, with all leases now being capitalized on the balance sheet (save for limited exceptions for low value and short-term leases). This resulted in companies (a) recording a lease liability and a corresponding right-of-use asset on their balance sheet for all leases that were previously classified as operating leases and (b) accounting for payments under these leases as a mix of interest and depreciation (i.e., as add-backs to EBITDA instead of as operating lease payments).

The change has generally resulted in the following impacts to balance sheets, income statements and credit metrics (relative to the old rules), all of which have implications for bond and loan covenants:

- an increase in debt in the form of additional lease liabilities as a result of all leases being accounted for on the balance sheet
- a corresponding and roughly equal increase in assets to reflect the right-of-use assets

associated with these leases

- an increase in EBITDA because of the reclassification of operating lease payments as a mix of interest and depreciation
- typically, an increase in leverage because the percentage increase in debt generally exceeds the percentage increase in EBITDA
- an impact on coverage ratios, dependant on the increase to EBITDA (from the interest and depreciation components of lease payments) relative to the increase to interest expense

Why this matters for debt covenants

Without the distinction between capital and operating leases, practitioners have been forced to find new ways to distinguish between the types of leases that ought to be caught by debt covenants and those that should be outside their purview.

In the early days after implementation of IFRS 16, many companies relied on a drafting mechanism known as a “GAAP freeze” (i.e., specifying that covenant compliance will be determined based on the accounting policies in effect at a particular point in time) to preserve the concept of “operating leases” solely for covenant testing purposes. The GAAP freeze was intended as a temporary solution while the market developed a new standard practice for the treatment of leases under IFRS 16. But, five years after the implementation of IFRS 16, the GAAP freeze approach is still surprisingly common and a widely accepted market practice remains to be seen.

In the high yield bond context, progress has been made to move away from the GAAP freeze and to structure covenant patterns to work within IFRS 16. One approach (which was initially developed by Osler debt capital markets partners) is to simply treat all leases as debt, and to include customized permitted debt baskets to ensure the company has appropriate flexibility to enter into leases if it is unable to pass its general debt incurrence test. The baskets are designed to permit the types of leases that are normal course for the company's business (e.g., an energy producer should never be prohibited by a debt covenant from entering into surface leases for oil and gas properties) while also providing flexibility for more material lease financing and sale/leaseback arrangements based on a percentage of the company's assets or EBITDA. The key credit metrics (such as leverage tests) are also sized on the basis that all leases are accounted for as debt. This avoids separately accounting for capital and operating leases under outdated accounting rules and allows the company to calculate key credit metrics and baskets based on its financial statements. It also provides clarity for bondholders looking to understand key covenant and basket calculations based on the company's publicly disclosed financial statements.

The approach for investment grade bonds is complicated by the way many companies issue debt in the investment grade market — under a global trust indenture that is used for all series of bonds issued by the company. This creates a lowest common denominator effect, since any change to the covenant pattern would only apply to future issuances of bonds (unless the company pursues a bondholder consent), and the company may already have long-dated bonds outstanding that rely on the old accounting rules. As a result, some companies have hesitated to update their covenants on the basis that the benefits of doing so are outweighed by any execution risk caused by introducing covenant changes during an offering. Investment grade covenant patterns are also generally less affected by IFRS 16 given the limited scope of covenants in many indentures (and with many not including debt incurrence tests).

In the credit agreement context, largely, there has been a movement away from the GAAP freeze approach due to the administrative burden on companies required to prepare two sets of financial statements. It is also common in credit agreements to include language providing that a material change to accounting standards that materially affects financial terms or covenants triggers a re-negotiation of such covenants. The borrower and lender are required to negotiate in good faith to amend the covenants to measure the borrower's financial situation on the same basis as when the loan was made. Until any such agreement is reached, the GAAP freeze approach is used to calculate financial covenants.

What should companies be doing?

Companies should continue to assess the impact of IFRS 16 on their loan and bond covenants. For first time issuers in the capital markets, the GAAP freeze should be avoided and covenants should be drafted to fully account for IFRS 16. For issuers with existing high yield or investment grade bonds that rely on the previous accounting treatment, consideration should be given to making updates in future issuances of bonds so that, over time, the issuer's covenant patterns can move towards IFRS 16. For companies entering into credit facilities or refinancing existing facilities, covenants and other provisions including cash flow sweeps should also be drafted to fully account for IFRS.

It is also worth noting that, although there have been relatively recent changes to the treatment of leases under U.S. GAAP, the changes are not entirely consistent with IFRS 16, and U.S. GAAP continues to preserve the distinction between capital and operating leases. This leaves Canada without a U.S. market practice to consider and also has an impact when Canadian companies access the U.S. market, as U.S. market participants continue to be more familiar with the traditional structure of capital versus operating leases.