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The New Lease Accounting Rules - Implications for Financing Agreements

New updates to accounting standards issued by the Financial Accounting Standards Board (“FASB”) on February 25, 2016 and by the International Accounting Standards Board (“IASB”) on January 13, 2016 will dramatically change financial reporting with respect to leasing transactions. The Accounting Standards Update (“ASU”) issued by FASB, which mirrors the IFRS 16 *Leases* rules issued by the IASB in January, will affect all companies and organizations that lease assets. The new rules will require lessees to add to their balance sheets potentially large amounts of long-term lease obligations that were previously off-balance sheet items.

Under the current rules, companies have generally applied a classification test to determine the appropriate accounting treatment for lease arrangements. Under GAAP, leases are classified as either “operating leases” or “capital leases.” Under IFRS, leases are classified as either “operating leases” or “finance leases.” Under both GAAP and IFRS, operating leases are not currently reflected on the balance sheet of a lessee, and rent is expensed by the lessee and included on a straight line basis over the term of the lease. Under the new rules, with respect to any lease of more than 12 months in duration, a lessee will have to report an asset (the right to use the item being leased) and a liability (the present value of future rent) for each of his or her leases. Rent payments will be treated partly as “amortization” of the “right of use” and partly as interest charged on the rent payable. Consistent with current GAAP and IFRS, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification. However, unlike current GAAP and IFRS—each of which requires only capital leases to be recognized on the balance sheet—the guidance in the FASB’s ASU and in IFRS 16 *Leases* requires both types of leases to be recognized on the balance sheet. The new lease accounting rules have the potential to significantly impact the size of a borrower/lessee’s balance sheet assets and liabilities and non-GAAP/IFRS financial metrics such as EBITDA, as well as the calculation of leverage or coverage ratios and any other credit agreement or indenture provision that ties to either GAAP or IFRS.

IFRS *Leases* 16 becomes effective on January 1, 2019. For public organizations and companies, the new GAAP rules will become effective on January 1, 2019, and for non-public organizations and companies, the new rules will become effective on January 1, 2020. Borrowers negotiating loan agreements, indentures or amendments thereto between now and the time the new rules go into effect need to consider the potential impact of these changes on their agreements and should discuss the new rules with their accountants, legal advisors and lenders to determine how any resulting issues should be addressed. Many indentures and loan agreements already provide that the accounting rules in effect at the time of execution of the applicable agreement will continue to govern, notwithstanding changes that may occur to such rules in the future. Such provisions, which “freeze” GAAP or IFRS, as applicable, are sometimes accompanied by an agreement by the parties to negotiate an amendment in good faith at the time the new rules become effective. However, “freezing” the accounting rules in this way may necessitate the borrower’s preparation of two sets of financial statements (one prepared under the old rules and one under the new rules) as well as a reconciliation of the two, which may be burdensome for management. Borrowers whose financial statements will be significantly impacted by the new lease rules, and who will likely need to prepare two sets of financial statements upon effectiveness thereof, may want to consider alternatives to the now prevalent “freezing GAAP/IFRS” mechanic as a solution to the problem.