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Alert to borrowers and lenders: Significant changes to lessee accounting standards

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Effective for accounting periods starting January 1, 2019, International Financial Reporting Standards 16 (IFRS 16) has replaced International Accounting Standards 17 (IAS 17) as the accounting standard for leases for all Canadian entities reporting under IFRS. IFRS 16 represents a significant overhaul of accounting for lessees, with the distinction between an operating lease and finance lease now eliminated. The new lessee accounting rules will potentially impact new and existing financing agreements – in particular, on the calculation of financial covenants or restrictions on debt incurrence.

What follows is our list of the five most important considerations for borrowers and lenders under financing agreements, with a focus on Canadian entities applying IFRS:

1. Some industries are impacted more than others

Industries particularly affected include retail, airlines, professional services and health care where parties tend to use operating leases extensively.

2. Existing facility agreements may need to be amended

Parties may have intended terms such as “Financial Indebtedness,” “Borrowings,” “Interest Expense” and “Capital Expenditure” to only include obligations under finance leases, and negotiated financial covenants accordingly. The elimination of the finance versus operating lease distinction may cause interpretative difficulties. Inclusion of obligations related to operating leases may also trigger covenant breaches or events of default notwithstanding the fact that the borrower’s financial condition remains the same.

3. “Frozen GAAP” provisions can be operationally challenging over time

“Frozen GAAP” provisions allow the borrower to report on its financial position and calculate any financial covenants and other measures based on GAAP at a specified date pre-transition. However, borrowers may find it difficult and expensive to manage two sets of books long-term or to provide a reconciliation between new and “frozen GAAP” at every reporting date.

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4. Including clauses to allow terms to be renegotiated to address GAAP changes

These clauses would allow the borrower and lender to negotiate in good faith to revise financial ratios, covenants, standards or terms to ensure the borrower is evaluated on the same criteria before and after transition. Parties should also specify that the borrower must continue to calculate covenants and deliver financial statements during the negotiations.

5. No changes for Canadian private companies

Changes to IFRS only impact Canadian public companies or other companies which have elected to follow IFRS. As of writing, no changes have been proposed for lease accounting under the Canadian Accounting Standards for Private Enterprises 3065 (ASPE 3065), nor for other Canadian accounting standards related to not-for-profit organizations or public sector entities.

If you have any questions please contact Joyce Bernasek, partner in Osler's Financial Services Group.