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IFRS 16 - Changes that Impact Borrowers and Lenders are Coming to Canada - Are you Ready?

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On January 1, 2019, new accounting practices will affect all countries that employ the International Financial Reporting Standards (IFRS), including Canada. This new accounting standard, known as IFRS 16 – Leases (IFRS 16), is designed to increase transparency in current accounting practices by moving nearly all leases onto the balance sheet. This change could impact financial covenants and reporting obligations in loan agreements and other financing documents and as such, in anticipation of this change, borrowers and lenders should confirm how this change impacts their current loan agreements prior to the date of adoption of IFRS 16.

Major Changes

The major consequence of the adoption of IFRS 16 is that there will no longer be a distinction between capital leases and operating leases on a lessee's financial statements. Accordingly, borrowers and lenders will need to identify operating leases, which historically for the lessee were treated as statement of comprehensive income (income statement) items, on their balance sheet recognizing both the leased asset and the corresponding liability.

How Does this Affect Loan Agreements?

As a result of the move of operating leases to the balance sheet, there can be significant consequences to a borrower with a significant number or dollar value of leases which are currently treated as off-balance sheet items. The most apparent effect of the new IFRS 16 will be on a borrower's financial ratios in their loan agreements. First, borrowers that utilize a large number of operating leases will notice a change on their balance sheets as these leases are now classified as assets and liabilities. Accordingly, any ratios that utilize these terms, including asset turnover ratios, debt-to-equity ratios, current ratios and EBTIDA metrics, all which are common financial covenants in loan agreements, will also be impacted and should be tested in light of IFRS 16 treatment.

Lenders will need to consider if their current lending documents adequately deal with the changes that IFRS 16 will bring. Some loan agreements contain provisions freezing accounting standards to the standards applicable at the time that the agreement was made (often referred to as 'frozen IFRS' provisions), which may assist the Lender in navigating this change in the interim period. Furthermore, definitions of 'debt' in loan agreements and other financing arrangements should be reviewed to ensure that they capture leases that were historically off-balance sheet items, as such leases may have been explicitly excluded from, or not specifically included in the definition of debt.

Borrowers should consider the implications of the change in accounting policies on their financial ratios, and whether, on adoption of IFRS 16, they will be able to meet their financial covenants as currently contemplated. Furthermore, provisions of loan agreements with frozen IFRS provisions generally require burdensome financial reporting requirements as typically the borrower is required to prepare parallel financial reporting both including and excluding the adoption of IFRS 16. Borrowers should consider working with their lenders to amend loan agreements to deal with the implementation of IFRS 16.

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For more information on how the new IFRS 16 changes could affect you or your business, please contact Chuck Rich or Carla Potter at Cassels.
