FEEDBACK REPORT

IFRS 16 *Leases*: Consultation on the impact on financial covenants in loan agreements

December 2015

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Introduction

Background to the feedback report

1 IFRS 16 *Leases* is expected to be issued at the beginning of 2016 and will require the recognition of all identified leases on a lessee's balance sheet with only limited exceptions. Under the current requirements, operating leases are not recognised on a lessee's statement of financial position; operating lease commitments are disclosed in the notes.

2 Loan agreements may include financial covenants that require an entity to meet specified ratios based on accounting data. Concerns have been raised that the recognition of operating lease commitments as lease liabilities on a lessee's statement of financial position will affect financial covenants and may result in entities breaching those covenants.

3 However, the impact of these new requirements may not occur or be mitigated if agreements include clauses (a) such as use of 'frozen GAAP'[1] or (b) that require or allow renegotiation of covenants when accounting standards are changed.

4 In July 2015, EFRAG and the National Standard Setters of France, Germany, Italy, Lithuania and the UK launched a consultation to understand the impact of IFRS 16 on loan covenants; the IASB also participated in this consultation.

5 The results of the consultation will be considered by EFRAG in the context of its endorsement process for IFRS 16.

Replies received from constituents

6 Fifty-two replies to the consultation were received, fourteen from lenders and thirty-eight from non-lenders.

Definition of the terms used in the report

7 In describing the preliminary findings the following terms are defined:

(a) a few: below 25%;

(b) some: above 25% and below 50%;

(c) majority: above 50% and below 75%;

(d) large majority: above 75%; and

(e) almost all: above 90%.

8 In addition to the above-defined terms, this report uses the term 'half' when respondents' answers were split into two groups of similar size and the term 'one third' with a meaning of 30% to 35%.

General note

9 The public consultation asked different questions to *lenders* (entities that provide financing to clients) and *non-lenders.* Lenders were asked to provide information on the types of covenants that they typically include in the agreements with their clients, and to indicate:

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[1] In a typical 'frozen GAAP' provision, accounting data used for the purpose of financial covenants are maintained on the same GAAP basis as that existing at the date of the signing of the loan agreement. Thus, changes in accounting requirements do not affect financial covenants that include 'frozen GAAP' provisions.

(a) whether covenants are based on accounting data or other information (such as composition of ownership);

(b) whether covenants based on accounting data are determined based on financial statements prepared under IFRS or local GAAP;

(c) whether covenants are determined by taking into consideration operating lease commitments; and

(d) whether agreements include 'frozen GAAP' provisions, or automatic renegotiation clauses when accounting Standards change.

10 Lenders were also asked to indicate if they use different types of covenants for different classes of clients.

11 Non-lenders were asked to indicate what type of covenants are applied in their jurisdiction, based on their experience.

12 The number of responses from lenders was substantially less that the responses received from non-lenders (14 compared with 38).

13 Some identified inconsistencies between the replies of the two groups, may be explained by a different geographical coverage of the groups.

14 Respondents did not provide quantitative information about the number or percentage of agreements that would be impacted, or not impacted, by IFRS 16. Consequently, it has not been possible to reach conclusions about the expected quantitative impact of IFRS 16.

Executive summary

Lenders

15 The responses show mixed practice; some lenders reported that they apply different types of covenants for different clients, i.e. covenants are often tailored for the particular client. Nevertheless, a large majority of respondents stated that their loan agreements included at least one of the following features:

(a) automatic renegotiation clauses in the case of a change to accounting principles, at least for some of their agreements;

(b) 'frozen GAAP' provisions; or

(c) adjustments for operating lease commitments in determining covenants.

16 For loan agreements containing any of the above-mentioned features, the requirements of IFRS 16 are not expected, in isolation, to cause a breach of covenants. Furthermore, a large majority of lender respondents noted that they will reconsider the terms and conditions of covenants when IFRS 16 is effective, although it was not clear if those comments referred to new agreements or existing agreements.

17 Some respondents also reported that some of their covenants use non-accounting based measures[2].

Non-lenders

18 Non-lenders that responded were almost all preparers, with the exception of one professional consultant and one user.

19 The large majority of non-lender respondents (35) reported that their covenants were based on accounting data. Based on the replies and the available information, the

2 Examples of such covenants are provided in paragraph 22 of this document.

covenants of the majority of non-lender respondents (27) either (a) are not expected to be impacted or (b) are expected to be renegotiated if IFRS 16 affects covenant ratios.

Detailed answers

20 Not all respondents replied to all questions. Therefore, the total of respondents indicated for each finding does not always equal to the total number of respondents.

Lenders

21 The large majority of lender respondents reported that different financial covenants are applied depending on the size of the loan (8 of 11) and/or the size of client (9 of 12). A majority (8 of 12) of the respondents reported that several characteristics of clients could impact the determination of the financial covenants applied. The respondents provided the following explanations:

(a) in different industries there are different types of standard covenants;

(b) the choice of covenant is impacted by local market practice;

(c) for large clients or large borrowings, covenants are negotiated and are often adjusted to reflect the individual circumstances of the client or borrowing; and

(d) covenants are impacted by the credit quality of the borrower.

22 Half (4 of 8) of the lender respondents reported that they may use financial covenants not based on accounting data, and in those cases consider factors such as:

(a) structure of ownership;

(b) structure of sales;

(c) changes in the structure of the group or the nature of the business;

(d) dividend pay-out ratio; or

(e) changes in management or change in control.

23 Nevertheless, all of the lender respondents reported that they also use financial covenants based on either IFRS or local GAAP figures.

24 A large majority of lender respondents (11 of 14) reported that, at least in some cases, agreements either include ‘frozen GAAP’ provisions, are automatically renegotiated in case of a change in accounting standards, or are already adjusted for operating lease commitments (although less frequently in relation to profit or loss).

25 Moreover, a large majority of the respondents reported that:

(a) financial covenants may be, and in practice are, renegotiated (10 of 12); and

(b) they plan to change their approach for future agreements or adjust the level of ratios after the introduction of IFRS 16 (8 of 10).

Non-lenders

26 The large majority of non-lender respondents (35 of 38) reported that financial covenants are based on reported figures.

27 The survey noted that covenants could be impacted by IFRS 16 if all of the following conditions apply:

(a) the covenant is based on accounting data from the financial statements;

(b) the calculation of covenant ratios does not include adjustments for operating lease commitments; and

(c) the agreement does not include ‘frozen GAAP’ provisions.

28 Of the 36 non-lender respondents[3], 19 reported that their covenants met all of these conditions. However, of those 19 respondents, half expect that they will be able to renegotiate their covenants upon adoption of IFRS 16.

29 The actual risk of breaching covenants under these conditions depends on whether, among other factors, an entity has, or will have, significant operating lease commitments that will be recognised as lease liabilities under IFRS 16. Some of the non-lender respondents reported limited operating lease commitments, however, it was not possible to assess the impact of those commitments on their loan covenants.

30 One non-lender respondent with significant operating lease commitments indicated that IFRS 16 is likely to impact covenants within a number of long-term bond agreements, and it is likely to need to renegotiate those bond agreements.

31 Another non-lender respondent expressed a concern that the banks could use the introduction of IFRS 16 as an opportunity to renegotiate covenants in the favour of the lender and suggested that a longer period (3–5 years) is allowed before the effective date of IFRS 16 so that there is sufficient time to enable a natural churn of renewing bank facilities (including covenants) on the new basis.

32 There was some consistency in information provided by non-lender respondents from the same country. For example, the large majority of Lithuanian non-lender respondents (7 of 8) indicated that covenants met all of the conditions in paragraph 27 above; whereas only a few German respondents (3 of 12) indicated this was the case; and half of UK respondents reported that they have 'frozen GAAP' provisions in covenants.

3 This number excludes two responses for a consultant and a user.

APPENDIX 1: List of Respondents - Lenders

List of respondents – lenders	
Name of respondent	***Country***
AB SEB bankas	Lithuania
ALPHA BANK SA	Greece
Bankinter S.A.	Spain
Barclays	United Kingdom
Danske Bank A/S	Denmark
Deutsche Bank	Germany
Helaba	Germany
ING Poland	Poland
Libra Internet Bank	Romania
MARFIN BANK	Romania
PIRAEUS BANK S.A.	Greece
RAIFFEISEN BANK SA	Romania
SEB AB	Sweden
UniCredit Tiriac Bank SA	Romania

APPENDIX 2: List of Respondents - Non-lenders

List of respondents – non-lenders	
Name of respondent	***Country***
AB INVALDA INVL	Lithuania
AMPLIFON S.p.A.	Italy
APB Apranga	Lithuania
Daimler	Germany
Deutsche Lufthansa AG	Germany
Energijos tiekimas, UAB	Lithuania
Engie	France
Essentra	United Kingdom
Evonik Industries AG	Germany
Farstad Shipping ASA	Norway
Finmeccanica	Italy
Fitch Ratings (*replied in its capacity as a user)*	United Kingdom
Franz Haniel	Germany
Freudenberg & Co.	Germany
Grieg Star	Norway
Hilton Food Group	United Kingdom
HORNBACH HOLDING AG	Germany
Ista	Germany
J. Lauritzen A/S	Denmark
John Lewis	United Kingdom
K+S Aktiengesellschaft	Germany
Kauno Energetikos Remontas, UAB	Lithuania
LANXESS AG	Germany
LESTO AB	Lithuania
Lietuvos Energijos Gamyba	Lithuania
London Stock Exchange Group	United Kingdom
Møller - Mærsk A/S	Denmark
NYK Group Europe	United Kingdom
Pennon Group	United Kingdom
Pierino Postacchini, BP&A	Italy
Progress Housing Group	United Kingdom
Südzucker	Germany
The Linde Group	Germany
ThyssenKrupp AG	Germany
Torvald Klaveness	Norway
UAB Duomenų logistikos centras	Lithuania
UAB LITGAS	Lithuania
Vodafone Group	United Kingdom

APPENDIX 3: Summary of Lender and Non-lender Respondents by Country

Total respondents by country			
Lenders		***Non-lenders***	
Romania	4	Germany	12
Germany	2	United Kingdom	9
Greece	2	Lithuania	8
Denmark	1	Italy	3
Lithuania	1	Norway	3
Poland	1	Denmark	2
Spain	1	France	1
Sweden	1		
United Kingdom	1		
	14		**38**