The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have published proposals on the accounting treatment of leases. The comment deadline was 15 December 2010 and the intention is to issue a new standard on lease accounting in 2011. If the proposals are put into effect as drafted, the current dual accounting system for operating and finance leases will be abolished. Borrowers and their lenders will need to consider the effect on their facilities agreements and in particular on any financial covenants, financial definitions and restrictions relating to financial indebtedness contained in those agreements.

While sectors that made the most extensive use of operating leases (retailers, hoteliers, aircraft and shipping) will be most affected by the rule change, any company that currently accounts for any of its leases as operating leases will be affected. The extent to which leases are taken into account in calculating financial covenant ratios and financial indebtedness incurrence covenants in facilities agreements usually depends on the accounting treatment given to the particular lease for the company’s financial statements. In most cases, the definitions and financial covenants are drafted by reference to the accounting term “finance lease”.

**THE DUAL SYSTEM** Under the current accounting regime, leases are classified as operating leases or finance leases. For the lessee, operating leases remain off balance sheet, with any lease payments charged to the profit and loss account (P&L) as an operating expense and therefore not typically considered as debt in calculating the financial indebtedness covenant or the financial covenants under facilities agreements. Conversely, finance or capital leases are recognised on the balance sheet and so are typically included as debt in the financial covenant calculations under facilities agreements.

The IASB/FASB proposals envisage abolishing this dual system and adopting a unified approach where all leases are accounted for in a consistent manner that has some similarities to the current finance lease treatment. Each lease will need to be considered individually and factors such as discount rates, the lease and lease payment periods, together with any residual value guarantees or penalties, will all play a part in determining the value and the accounting treatment of any particular lease; and that will in turn determine their effect on the relevant covenants. As a general rule, the following will apply:

1. The right to use the asset underlying the lease will appear on the balance sheet as an asset, with the value of the asset reducing over time as the lease term expires;
2. The present value of future payments will appear on the balance sheet as a liability and again will reduce over time but not necessarily at the same rate that the lease asset is depreciated;
3. The interest element of the lease will be charged to the P&L as a
finance expense and, once again, this will reduce over time as the amount of future capital payments reduces; and
4. There will be an annual depreciation charge to the P&L over the life of the lease equal to the reduction in its asset value.

All leases will be referred to as leases and the distinction between operating lease and finance lease will become obsolete.

**THE EFFECT ON FINANCIAL COVENANTS**
The current dual treatment of leases is reflected in the drafting of financial covenants, related definitions and financial indebtedness incurrence covenants in facilities agreements, which typically purport to capture only those obligations generated by finance leases. Any restrictions or limits relating to financial indebtedness – for example, a permitted basket for finance leases – will therefore need to be reviewed.

Lenders may argue, following the proposed change and the abolition of the finance lease classification, that any reference in financial definitions to “finance lease” should be interpreted to include any and all leases. Conversely, borrowers could assert that no leases are included.

The potential impact of the proposed change on certain financial definitions and the financial covenants is analysed under the three subheadings below and summarised in the table overleaf.

**Financial indebtedness and total debt**
Definitions of financial indebtedness (used to restrict the amount of indebtedness the group may incur or as a cross default trigger) and total debt (used to calculate leverage ratios) capture only the capital element of payments under any lease or hire purchase contract. In accordance with accounting principles, it would be treated as a finance or capital lease.

By definition this currently excludes any amount payable for operating leases. Under the proposals, as there will no longer be a distinction between operating and finance leases, both the financial indebtedness and total debt definitions could be determined to include any amount payable under any lease that is accounted for as a liability in the balance sheet (in other words, the present value amount of any future capital payments referred to in point 2 above).

**EBITDA**
EBITDA (earnings before interest, taxes, depreciation and amortisation), used in the leveraged and interest cover ratios and as a base for the fixed charge cover ratio, is currently reduced by rental payments on operating leases, these being deducted as a general operating expense of the company. Under the proposals, this will no longer be the case. The effect on EBITDA will therefore be positive.

However, while EBIT will benefit from the reduced operating expense, it will also be negatively affected to the extent of the increased depreciation charge that will result from the change (that is, the amount referred to in points 3 and 4 above).

**Finance charges**
Definitions of finance charges (used for interest cover and fixed charge cover covenants) generally purport to capture only the interest element of payments under finance leases, and therefore, under the current rules, exclude any rental payments under an operating lease. Under the proposals, finance charges could capture the interest element of any lease payment. Also, the finance charge is calculated using the effective interest rate method, which has the effect of front-loading the interest cost to the early years of the lease.
WILL THE CHANGES TRIGGER A BREACH OF FACILITIES AGREEMENTS? If we assume that the relevant definitions are interpreted to include leases, financial indebtedness will be increased as a result of the change in the accounting treatment. There is a significant possibility that borrowers may be in default as a result, particularly in industries that rely heavily on operating leases (which currently do not typically have an impact on financial indebtedness).

The extent to which the changes will be taken into account when calculating the financial covenants will depend on the terms of the facilities agreement and whether the borrower is required to deliver its financial statements as frozen GAAP (which is standard practice in leveraged finance transactions) or floating GAAP (which is more typically found in investment-grade transactions). Although there is no explicit language in the LMA facilities agreement to support this, it would seem appropriate for a treatment consistent with that applied to the financial covenants to be applied to the determination of financial indebtedness.

Under a frozen GAAP provision, each set of financial statements has to be prepared on the same basis as the original financial statements, unless there has been a change in GAAP. Where there has been a change, borrowers are required to reflect the changes in GAAP, but the auditors must also provide a reconciliation statement to enable the lenders to determine whether the financial covenants have been met on the basis on which they were set. In other words, the change in accounting treatment will not affect the calculation of the financial covenants. If, however, the facilities agreement provides for financial statements to be prepared on the basis of floating GAAP, changes in accounting treatment will be taken into account.

BE PREPARED Borrowers would be well advised to prepare for the effect of the proposed accounting change on the treatment of leases and to consider the likely impact on their financing documentation. The standard is expected to come into effect for accounting periods beginning on or after 1 January 2013 and with prior year comparatives to be prepared. This will enable parties to address the issues in advance of the change taking effect.

Lenders and borrowers will need to review their facilities agreements to see whether the proposed changes will result in leases which have previously been ignored for the purposes of any financial indebtedness restrictions and/or the financial covenants being brought into account. To the extent that they are, a consideration of any floating or, as appropriate, frozen GAAP provisions will be necessary to determine the requisite steps to be taken.

Where facilities agreements provide for floating GAAP, there is clearly a potential issue and a need for amendment, waiver or covenant adjustments to take account of the changes. Where facilities agreements provide for frozen GAAP, although there may not be an immediate impact, it may be unclear whether any financial indebtedness definitions are frozen; and even if such items are frozen, the delivery of reconciliation statements would require the borrower to maintain two sets of accounts, which is not likely to form a viable long-term solution.

Lenders and borrowers entering into new or amended facilities agreements should take account of the potential impacts outlined in this article. They should ensure that the relevant provisions are drafted so as to anticipate the change, with the result that those leases which they agree should be treated as a liability of the company are included as such.

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1 It cannot be assumed that the increase in EBITDA will balance the increase in total debt. Where EBIT, rather than EBITDA, is used, there will be a deduction to the extent of the increased depreciated charge resulting from the change in accounting treatment of leases.