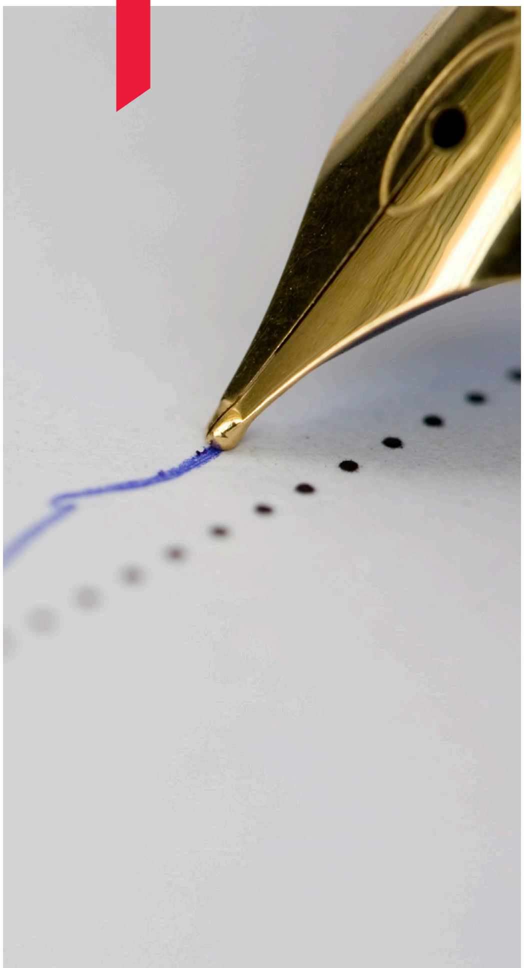
# CHEAT SHEET

## BANK COVENANTS: UNDERSTANDING THE IMPACT IMPOSED BY THE NEW ACCOUNTING FOR LEASES



### BACKGROUND

For reporting dates 31 December 2019 and onwards, the long awaited new accounting standard regarding leases (NZ IFRS 16 *Leases*) comes into effect for *for-profit entities* who apply NZ IFRS.

NZ IFRS 16 results in a fundamental change in the way that lessees will need to account for most of their lease agreements.

As a result, the reported numbers across all of an entity's primary financial statements (i.e. position, performance, and cash flow) will change.

Consequentially, financial metrics such as *earnings before interest, depreciation, and amortisation* [EBIT(DA)], net profit, [times] interest, gearing (debt vs. equity), leverage (debt vs. assets), and working capital, will also be impacted.

Many of these financial metrics feed into various bank covenant calculations that an entity may be subject to.

Having unknown and/or unresolved bank covenant breaches as at reporting date results in some rather harsh reporting consequences under NZ IFRS – even if the breaches are ultimately remedied/waived by the bank after reporting date.

As such, entities need to be vigilant of, and proactive to, their exposure to the impacts of NZ IFRS 16 with respect to bank covenants.

This *Cheat Sheet* has been produced as a high-level overview of the potential impact and consequences of NZ IFRS 16 on bank covenants, and what entities adopting NZ IFRS 16 for the upcoming 2020 reporting year ends can and should be doing to address this.

### NEED ASSISTANCE WITH YOUR ADOPTION OF NZ IFRS 16?

BDO *IFRS Advisory* is a dedicated service line available to assist entities in transitioning to NZ IFRS 16. Further details are provided on the following page for your information.

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### WHAT IS COVERED IN THE *CHEAT SHEET*

In order to navigate through this area of NZ IFRS 16, this *Cheat Sheet* is broken down into the following sections:



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### 1. What are bank covenants

When a bank initially lends an entity money, they do so after taking a calculated risk that the entity will be able to pay them back.

In order to protect and safe guard this, banks will include "covenants" in the lending agreements.

Broadly there are two types of bank covenants:

**(i)** **Protective**: Covenants that require an entity to do (or not do) certain things – i.e. not take on additional debt; to provide audited annual financial statements by a set date etc.

**(ii)** **Reporting**: Covenants that require an entity to stay within certain pre-agreed ranges/thresholds of financial metrics and ratios. Common examples of these include:

- Gearing ratios (debt to equity).
- Leverage ratios (debt to assets).
- Times interest ratios (that earnings before interest and tax [EBIT] remains a certain level above interest expense.
- Working capital ratios (current assets to current liabilities).

The objective of these reporting covenants is to act as "warning bells" that an entity's financial position, performance, and/or credit risk may be deteriorating - thereby putting repayment of the debt owed to the bank in jeopardy.

As such, when bank covenants are breached, the bank (typically) has the contractual right under the lending agreement to demand **<u>immediate repayment</u>** of the debt in full.

## 2. How does NZ IFRS 16 impact bank covenants

From previous *Cheat Sheets*, entity's will be aware that NZ IFRS 16 fundamentally changes the way that leases are accounted for by lessees, resulting in wide ranging changes to reported financial position, performance, and cash flows, including:

- Gearing ratios (debt to equity).
- Leverage ratios (debt to assets).
- Times interest ratios (that earnings before interest and tax [EBIT] remains a certain level above interest expense.
- Working capital ratios (current assets to current liabilities).

Many of these feed into the calculations and determinations of the financial metrics upon with (reporting) bank covenants are based.

So if these are changing… so too is an entities potential compliance (or not) with its (reporting) covenants.

## 3. Are an entity's bank covenants actually exposed to NZ IFRS 16 impacts

### (i) General exposure

The lending agreement will specify on what basis the amounts, balances, and/or financial metrics used in (reporting covenants) are determined.

This will vary bank-to-bank, entity-to-entity, and lending agreement to lending agreement.

If the lending agreement refers to, and only to, "NZ IFRS", or "NZ GAAP" (New Zealand generally accepted accounting practice) then the bank covenants are fully exposed to the accounting impacts of NZ IFRS 16.

Alternatively, this may not be the case if the lending agreements explicitly states that the (reporting) covenants:

- Are determined based on NZ IFRS/NZ GAAP as issued at a point in time that is prior to 1 January 2019 (i.e. the date NZ IFRS 16 became effective), and/or
- Exclude the application of NZ IFRS 16.

### (ii) Specific exposure

The lending agreement may provide definitions of what financial metrics such as "debt", "interest", "current liabilities", "working capital" etc. does (and does not) include.

Therefore, even if an entity's (reporting) covenants are *generally exposed* to the impacts of NZ IFRS 16 (as detailed above), this may be (fully, or partially) mitigated depending on how the relevant financial metrics are specifically defined in the lending agreement, for example:

- "Debt" and "interest" including only bank debt and interest on bank debt
- "Current liabilities" excluding the current portion of long-term debt, and/or
- "Assets" including only tangible non-current assets.

## 4. What are the consequences of breaching bank covenants

### (i) The actual, practical consequence

As detailed above, when bank covenants are breached, the bank (typically) has the contractual right under the lending agreement to demand immediate repayment of the debt in full.

This obviously has a real-world, practical, cash outflow impact to an entity.

### (ii) Financial reporting disclosure impact

Details of breaches in bank covenants are required to be disclosed in the financial statements[1].

| Full NZ IFRS reporter | NZ IFRS (RDR) reporter |
|---|---|
| • Breaches of bank covenants as at reporting date, even if remedied/waived.<br>• Breaches of bank covenants during the reporting period, unless they were remedied/waived).<br>*Therefore if bank covenants are required to be reported more frequently than annually, there may be multiple instances of bank covenant breaches* | • Breaches of bank covenants that have not been remedied/waived by reporting date. |

### (iii) Financial reporting presentation impact (current vs. non-current)

An entity's balance sheet is a "point-in-time-snap-shot" of all the assets and liabilities as they exist at that point in time, incorporating only the facts and circumstances surrounding them that exist at that same point in time.

NZ IFRS has mutually exclusive criteria that distinguishes when liabilities are presented as "current", and "non-current"[2].

One of these being that if an entity is not (contractually, or legally) able to unilaterally defer settlement of a liability for the 12 months after reporting date, the balance **must** be presented (in full) as current

Accordingly, if **(a)** an entity has breached bank covenants as at reporting date, and **(b)** the breach has not been remedied or waived by the bank **by reporting date**; then the debt must be presented as current.

[1] NZ IFRS 7 para 18, para RDR 18.1, and para 19
[2] NZ IAS 1 para 69

Remedies or waivers by a bank after reporting date, **do not resolve** **(b)** above - that is, an entity is required to **(i)** disclose the breach; **(ii)** present the debt as current; and, **(iii)** disclose any subsequent remedy/waiver of the breach received from the bank after reporting date as a *non-adjusting* event, only.

This poses an obvious concern for entities still working through (or, yet to start) their adoption assessments of NZ IFRS 16, as some entities with NZ IFRS 16 exposure to their bank (reporting) covenants may only be finalising their results (i.e. confirming (reporting) covenant compliance (or not)) until some time after reporting date has already passed.

Accordingly, entities in such a position need to make sure they have their "ducks in a row" by the time their reporting date eventuates.

For entities with **31 March 2020 reporting dates**… this is only just around the corner.

## 5. What should entities be doing prior to reporting date

### (i) Investigate and confirm the entity's exposure

Bank lending agreements should be reviewed immediately so that management can determine whether the entity has *General and/or Specific* exposure to NZ IFRS 16 with respect to its (reporting) covenants.

Management should then seek confirmation of this determination with their bank, and if necessary, their auditor.

### (ii) Obtain formal remedies and waivers from the bank

If an entity is exposed to NZ IFRS 16 with respect to its (reporting) covenants, but is unlikely to have its NZ IFRS 16 adoption assessment finalised prior to reporting date, then whether or not an entity has complied with its (reporting) covenants will be unknown.

In this case entities should be approaching their banks, **prior to reporting date**, to either:

(a) Amend the lending agreement to either "scope out" NZ IFRS 16", or to appropriately adjust the (reporting) covenant thresholds, or

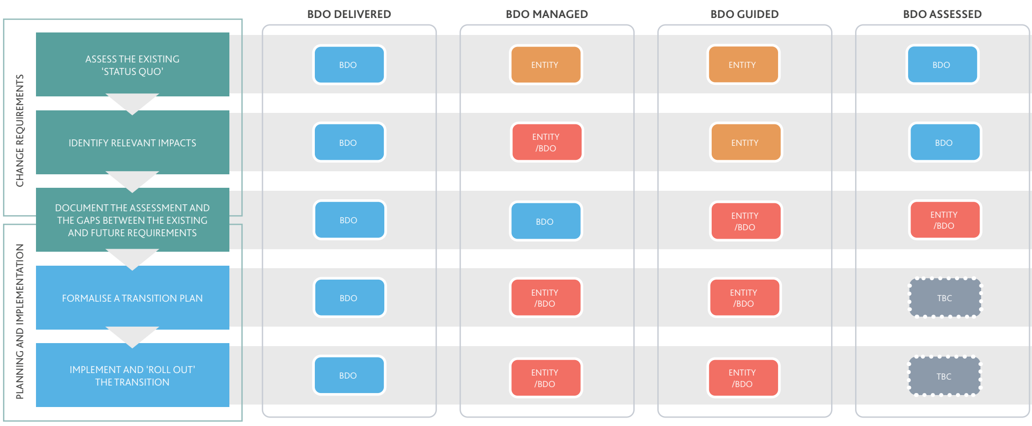
(b) Have the bank issue a pre-waiver, stating that the bank agrees to waive its right to call in the debt if the (reporting) covenants are breached on account of the specific impacts of NZ IFRS 16 accounting treatments.

Such a waiver **MUST** be issued by the bank prior to reporting date (for the reasons detailed in **4.** above).

## *BDO IFRS ADVISORY - TAILORED ADOPTION ASSISTANCE*

BDO adopts a flexible and fully customisable approach to assisting entities with their adoption of new accounting standards. This allows us to be as involved as an entity requires, so that this can be built around an entity's own existing in-house resourcing and expertise.

Often entities have an idea of what needs to be done, but don't know exactly where to start or focus their energies, and just want to get the ball rolling.




We have found our *BDO Guided* and *BDO Assessed* approaches fit well to accommodate this, whilst also retaining the ability to scale up involvement quickly if need be – either way, we work **WITH** you.

Members of BDO's *IFRS Advisory* department are well placed to provide expertise in the adoption of NZ IFRS 16. They have real-world experience on "both sides of the fence", both in (i) developing and executing Adoption Plans, and (ii) assessing and analysing the output of an entity's adoption.

For more information as to how *BDO IFRS Advisory* might assist with assessing the impact of your adoption to new accounting standards please contact James Lindsay at BDO *IFRS Advisory*
(james.lindsay@bdo.co.nz ☎ +64 21 166 0844), and visit our webpage below.

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