

New IFRS and U.S. GAAP Lease Accounting Rules Impact M&A Transactions

IN SHORT

The Situation: New rules for the accounting of operating leases will come into force under the International Financial Reporting Standards ("IFRS") and U.S. Generally Accepted Accounting Principles ("U.S. GAAP") in 2019.

The Result: Lessees have to recognize assets and liabilities for operating leases on their balance sheets under these new rules and, under IFRS, move the costs of operating leases from operating expenses to depreciation and interest expenses, which will result in an increase of Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA").

Looking Ahead: Parties to M&A transactions need to be mindful of these new rules when determining debt items and accounting principles for closing accounts to be prepared beginning in 2019 and beyond and when agreeing on EBITDA based earnouts under IFRS extending into 2019 and beyond.

New lease accounting standards under IFRS (IFRS 16) and U.S. GAAP (ASC 842) were published as part of a joint effort by the IFRS and U.S. GAAP standard setters to improve the accounting for leases in 2016. IFRS 16 comes into force for financial years beginning on or after January 1, 2019, while ASC 842 comes into force for public companies for financial years beginning after December 15, 2018, and for most private companies for financial years beginning after December 15, 2019, but can be adopted earlier.

What's New?

The new rules primarily change how lessees have to account for operating leases, which are currently just reflected as operating costs in the profit and loss statement but are not recognized on the balance sheet. IFRS 16 abolishes the distinction between operating and finance leases. Rather, all leases will be treated similar to how finance leases are currently treated—a "right-to-use asset" and a financial liability have to be recognized on the balance sheet representing the net present value of the future lease payments, and the costs of all leases are reflected in the depreciation of the leased assets and as an interest expense. ASC 842 treats leases in a similar way, except that the costs of operating leases are captured in a single expense item in operating costs rather than through depreciation and interest expenses.



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Both assets and financial liabilities on the balance sheets of lessees will increase as a result of these changes. Furthermore, the EBITDA of lessees will increase under IFRS but not under U.S. GAAP. This has the following impacts on purchase agreements in M&A transactions:

Increase in EBITDA / Earnout

If the parties agree on an EBITDA based earnout under IFRS spanning the period of 2019 and beyond, the parties should be mindful of the jump in EBITDA caused by IFRS 16. If they want to avoid such jump, EBITDA must be determined disregarding the changes introduced through IFRS 16 for purposes of the earnout.

Lease Liabilities as Debt Items?

For closing accounts prepared beginning in 2019 and beyond under IFRS or U.S. GAAP, the parties will have to agree whether to treat liabilities for leases as debt and, if so, how to value such liabilities. If the buyer uses a discounted cash flow valuation to determine the enterprise value, liabilities for leases should be treated as debt if the lease payments have not been reflected in the enterprise value, i.e., if the buyer disregarded them as financing cash outflows. If the buyer uses an EBITDA multiple to determine the enterprise value, liabilities for leases should be deducted if the lease costs are not reflected in EBITDA. This will definitely be the case under IFRS, but this will only be the case for finance leases under U.S. GAAP. However, even under U.S. GAAP, a buyer might want to adjust reported EBITDA of the target to exclude costs for operating leases so that it can compare the target's EBITDA on an apples-to-apples basis to the EBITDA numbers of the target's peer group, including peers using IFRS.

Valuing Lease Liabilities in Purchase Agreements

If liabilities for leases will be deducted from the enterprise value for purposes of closing accounts, the next question is how to value them. With respect to liabilities for operating leases, simply referring to the balance sheet liability might not be appropriate because such liability only reflects the net present value

of the lease payments for the remaining term of the lease. If the remaining term is short, the liability would be very low, and such a low liability might be inappropriate given that costs for operating leases currently reduce the enterprise value at potentially much higher amounts—either the net present value of all future lease costs, including for replacement leases, (when using a discounted cash flow valuation) or a multiple of the annual lease costs (when using an EBITDA multiplier). Therefore, the parties may want to agree to value liabilities for operating leases differently than under IFRS or U.S. GAAP.

The liability reflected on the balance sheet might be more appropriate for finance leases because finance leases usually either span the useful life of the leased asset or contain an obligation for the lessee to purchase the leased asset at the end of the lease period, the costs of which also must be reflected in the net present value of the lease liability.

If the parties want to determine the value of lease liabilities differently than under IFRS or U.S. GAAP for purposes of the closing accounts, they have to accurately define the valuation metrics in the purchase agreement. Even if the parties will use the book values to determine lease liabilities, it might be advisable to agree on certain metrics for calculating the book values in order to avoid disputes, such as the discount rate, whether to assume that an option to extend a certain lease will be exercised, and future reinstatement costs, all of which are reflected in the net present value of lease payments.

Asset Deals

In asset purchase agreements a working capital adjustment at closing was often sufficient because net debt items are usually not transferred in asset deals. However, it might become necessary in the future to deduct liabilities for operating leases from the enterprise value at closing if the buyer assumes operating leases from the seller and the costs for such operating leases are not reflected in the enterprise value.

FOUR KEY TAKEAWAYS

1. The new lease accounting rules move operating leases onto the balance sheet and (under IFRS) increase EBITDA.
2. Parties agreeing on an EBITDA based earnout under IFRS spanning 2019 and beyond need to be mindful of the jump in EBITDA.
3. For transactions closing in 2019 and beyond that provide for closing accounts, the parties need to define whether to treat liabilities for leases as debt items and how to value these liabilities.
4. In asset deals closing in 2019 and beyond, it might become necessary to add a net debt adjustment to the working capital adjustment.

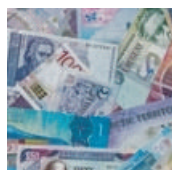


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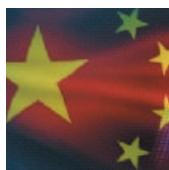
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