MARCH 2018

LEASE ACCOUNTING:

IMPACT OF UPCOMING CHANGES TO PRIVATE LENDERS

Sophisticated private lenders track a wealth of information relating to their business. This data is provided to stakeholders in various ways; covenant ratios under banking facilities, capital adequacy requirements reported to securities commissions and financial performance metrics reported to investors are three main examples. For this reason, it is important that boards and audit committees are informed about changes to accounting standards and understand their implications on reporting to their key stakeholders. This paper will outline some significant changes to lease accounting and demonstrate the importance of planning ahead to avoid surprises when reporting to these key stakeholders.

Current Accounting

When considering leases, the current position is clear. Anything considered a current liability under International Financial Reporting Standards (IFRS) accounting rules is also considered in the working capital calculation. The main lease liabilities that could appear in your financial statements relate to finance leases, where it is deemed that you have substantially all of the risks and rewards relating to the asset and therefore must capitalize the asset and recognize the lease liability. The current portion of the lease liability represents part of your working capital requirement. For finance leases, the accounting and corresponding impact on working capital requirements is intuitive.

However, consider the following example. You commenced an office lease on May 1, 20XX for $10,000 a month over a five year period. Under the accounting rules, since the term of the lease is only five years and the building has a significantly longer useful life, it is considered an operating lease and no liability is recognized. However, the lessor provided a six month lease holiday at the start of the lease. Total lease payments would be $540,000 over the five year period. Current IFRS accounting rules require rent payments to be recognized on a straight-line basis over the life of the lease. This would result in a straight line expense of $9,000 per month. Your accounting for the period to December 31, 20XX would look like this:

	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Lease expense	9,000	9,000	9,000	9,000	9,000	9,000	9,000	9,000	$72,000
Deferred rent liability	9,000	9,000	9,000	9,000	9,000	9,000	(1,000)	(1,000)	$52,000
Cash							10,000	10,000	$20,000

BDO

Your deferred rent liability of $52,000 would reduce by $1,000 each month, meaning you would recognize a current liability of $12,000 and a long-term liability of $40,000. The $12,000 is factored into your working capital requirements, which seems strange given your actual cash outflow over the next twelve months is $120,000.

Proposed Changes

Examples like these did not go unnoticed by the standard setting bodies. Research done by the International Accounting Standards Board (IASB) and their US counterpart, the Financial Accounting Standards Board (FASB), determined that the current standards for leasing (particularly for lessees) drew arbitrary lines between operating ('off balance sheet') and finance/capital ('on balance sheet'), as the existing guidance was interpreted as creating 'bright line' rules that lessees and lessors used to structure leases. To avoid recognition in financial statements, lease agreements were being written to avoid finance lease classification by lessees. This resulted in situations where two leases were nearly identical in every way except one was for an insignificantly longer period of time than the other, but resulted in a different accounting treatment.

Additionally, off balance sheet treatment created significant differences in financial reporting for entities that opted to purchase assets as opposed to entities that leased them, when both situations yielded common financial realities; the conveyance of the use of an asset in exchange for consideration.

In the boards' research, they also determined that many users of financial statements were already making adjustments to IFRS compliant financial statements to capitalize off balance sheet lease commitments. For example, many lending institutions were adjusting property plant and equipment and financial liabilities by an approximate figure using the lease commitments as disclosed in an entity's financial statements. This practice illustrated to the boards the need to reconsider lease accounting standards, especially considering that based on the boards' review of this estimation technique, financial statement users were generally overstating financial liabilities.

The result of these discussions was a revised leasing standard (IFRS 16). Under the new standard, all leases are recognized in the statement of financial position as a 'right of use' asset and a financial liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low value and for leases classified as short-term in nature (generally determined to be 12 months or less). The asset is subsequently accounted for in accordance with the cost or revaluation model in IAS 16 Property, Plant and Equipment or as Investment Property under IAS 40 Investment Property. The liability is unwound over the term of the lease using an appropriate discount rate.

The effective date of IFRS 16 is for annual reporting periods beginning on or after January 1, 2019.

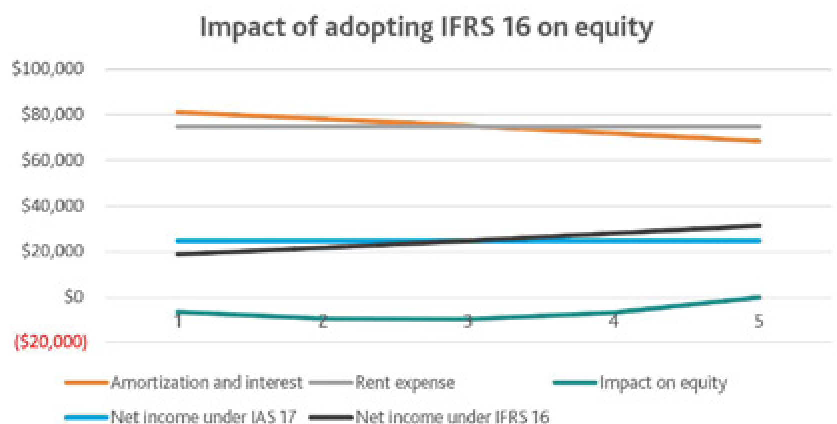
Impact on Private Lenders

The presentation requirements under IFRS 16 may shift key metrics for entities significantly. EBITDA (earnings before interest, taxes, depreciation and amortization) is often a key measure of short-term profitability reported to shareholders. The timing of overall expenses being recognized in profit and loss will change, which will impact EBITDA in any given year. Consider this example:

Your operating company has $100,000 of revenue each year. You have a five-year lease for the floor of an office building. It costs $75,000 a year and has an incremental borrowing rate of 5% (the rate implicit in the lease is not readily determinable) and the net income is $25,000 per year. There are no other transactions.

The character of the expense changes significantly under IFRS 16, even though nothing has changed in reality. Rent expenses are now classified as amortization and interest charges, which will impact EBITDA.

The graph below illustrates the impact on net income and equity of adopting IFRS 16:



Under the current rules, EBITDA is $25,000 each year, but under the new rules, the lease expense is replaced with depreciation on the capitalized lease, which is added back to net income to arrive at an EBITDA of $100,000 each year. This will need to be explained to your investors in advance of implementing these changes so there are no surprises.

A case for standardization of metrics

Our research tells us that lenders use different definitions when calculating metrics to report to their investors. In some cases, these metrics are defined so the reader can understand how they are calculated. However, the lack of standardization makes comparability among different lenders difficult. This will be exacerbated by the implementation of IFRS 16.

Under IFRS 16, balance sheets will grow as the "right of use" asset and finance lease liabilities are recognized. This means that your leverage will appear higher (even though nothing has changed in the real world), since debt recorded on your balance sheet will increase. Your balance sheet will not look as strong when capital ratios are considered, since your equity will likely be a smaller proportion of total assets (as assets will increase when the "right of use" assets are capitalized).

The table below outlines some key metrics private leaders use and how they are impacted by these changes.

Metric	Impact
Income available for dividends	A Mortgage Investment Corporation is a flow-through investment vehicle that distributes 100% of its taxable income to shareholders. While net income may change due to the recognition of amortization on a leased asset and accretion / interest on the lease obligation, this may not affect taxable income. The actual amount declared as a dividend to reduce taxable income to nil is unlikely to change.
Net asset value	Net asset value is the total value of the assets less liabilities. Under IFRS 16, the "right of use" asset will be capitalized and amortized over the life of the asset. The finance lease liability will accrete based on the interest method, using a discount rate determined at the commencement of the lease, reduced by any payments made. As a result, while net asset value would not be affected on day one, since assets and liabilities would increase by the same amount, there would be differences over the life of the asset depending on how the amortization method and accretion of the liability differ.
Current ratio / working capital ratio	The current ratio / working capital ratio is the proportion of current assets to current liabilities. Current liabilities will increase by the proportion of the lease liability due in the 12 months after the balance sheet date. Current assets will likely not increase since the "right of use" asset will be a long-term asset (short-term leases are excluded from the scope of IFRS 16). This will cause a deterioration in the current ratio / working capital ratio in the absence of changes to current roles, and will cause Excess Working Capital, reported to the Securities Commission on NI 31-103 Form F1, to decrease.
Efficiency ratio	Lenders typically calculate efficiency ratios based on their proportion of operating expenses over revenue or contribution margin. Lease expenses are now characterized as amortization and interest, which may be classified as financing expense rather than operating expense. This will improve your efficiency ratio.
Management expense ratio	This depends on how the ratio is calculated. Many lenders use total expenses less certain adjustments (such as financing costs) as a percent of total assets. Other lenders use the mortgage portfolio balance as the denominator. Where total assets is used, capitalization of the right of use asset will increase total assets, which will improve your MER. Further, if financing costs are excluded from total expenses, lease costs that were previously included would be left out. Again, this will improve MER.
Financing costs	These will increase as lease costs will be characterized as financing costs.
Debt service ratio	Many lenders use net operating income as a percentage of interest and principal payments required in the upcoming year. Re-characterizing lease expenses as financing costs will increase net income. Whether the debt service requirement also increases depends on how the banks defined this requirement i.e. were lease commitments included in the definition?
Operating cashflow	IFRS 16 will have no impact on net cash flows, but in the presentation of cash flow statements is likely to lead to an increase in operating cash inflows, with a matching increase in financing cash outflows. Principal payments on leases will be classified as financing activities, and under IAS 7 interest can be classified under operating, investing, or financing cash flows.

The real impact on your business

It is clear that the implementation of IFRS 16 will impact the metrics you report to investors and bankers. This will have a real impact on your business. You will need to review your bank covenants and definitions to determine how they will change. Consider this example of a Debt to Tangible Net Worth Ratio:

Debt is defined as all liabilities listed on the balance sheet less loans from shareholders or affiliates where the bank has a registered postponement of claim.

Under IFRS 16, this ratio will deteriorate because lease commitments are no longer excluded and will be recognized as a liability on the balance sheet.

Perhaps you negotiated a "frozen GAAP" clause, which states that the covenants are based on GAAP applicable at the date of signing. If this is not the case, you will need to understand how your covenants will change and consider updating your banking agreements.

Further, consider this performance fee calculation example:

Performance fees are based on 20% of the amount by which the net return for that year exceeds the average month-end NAVs during such year.

Since the timing of expenses recognized will change, the net return on a MIC investment will also change. Further, the NAV will also be different at any given point in time after initial recognition of the asset and liability. Performance fees paid to the portfolio managers may therefore change as a result of the accounting changes.

We recommend a full review of your legal documents or any items that are impacted by your GAAP numbers. For more IFRS insight visit our IFRS Knowledge Centre.

BDO specializes in providing accounting and advisory services to the private lending industry. We can advise you on the changes required to investor and regulatory reporting as a result of implementing IFRS 16. We advise planning ahead to avoid unnecessary surprises to your investors or the securities commission. If you have questions, contact a BDO advisor today.

TO LEARN MORE, CONTACT YOUR LOCAL BDO OFFICE OR:

Graham Marjoribanks, CPA, CA
Partner
403-531-0564
gmarjoribanks@bdo.ca

Sam Khoury, CPA, CITP, CRISC
Partner
416-369-6030
skhoury@bdo.ca

ABOUT BDO

BDO is a leading provider of professional services to clients of all sizes in virtually all business sectors. Our team delivers a comprehensive range of assurance, accounting, tax, and advisory services, complemented by a deep industry knowledge gained from nearly 100 years working within local communities. As part of the international BDO network, we're able to provide seamless and consistent cross-border services to clients with global needs.

Assurance | Accounting | Tax | Advisory
www.bdo.ca

BDO Canada LLP, a Canadian limited liability partnership, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms.