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IFRS changes cause concern for Canadian companies

An in-depth analysis of what the new standards will mean for your business and how companies can prepare

EXECUTIVE SUMMARY

In March 2006, after extensive consultation, the Canadian Accounting Standard Board (the "AcSB") approved a strategic plan to govern its activities in the upcoming years. As part of the strategy, the AcSB proposed the adoption of globally accepted standards by replacing existing Canadian Generally Accepted Accounting Principles ("GAAP") with International Financial Reporting Standards ("IFRS") for publicly accountable enterprises ("PAE"s).

In February 2008, the AcSB announced that the changeover to IFRS for publicly accountable profit-oriented enterprises is effective for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. This changeover is driven largely by the long-run public policy objective of enhancing the global comparability of the financial statements of Canadian entities.

As 2011 rapidly approaches and Canadian PAEs prepare for IFRS transition, a considerable amount of effort is being undertaken to understand the impact of differences between Canadian GAAP and IFRS, including a consideration of the consequential impacts on the business, processes and systems, to name just a few. This considerable effort is taking place in an environment where standards continue to change. As Canadian companies contemplate the future of IFRS, they must not only stay abreast of changes to IFRS, but also consider how such changes will differ from what they will adopt in 2011.

Lease accounting is an example of a proposed change to IFRS that is expected to have a significant impact if implemented as a final standard, notwithstanding the practical challenges associated with applying the proposed changes, the associated business-process issues, and commercial implications on the real estate sector.

According to Tom Rothfischer, KPMG's Real Estate Audit Practice Leader, "some may see the changes as a step forward for lessee accounting, allowing a clearer picture of an entity's assets and payment obligations. From a financial statement user's perspective, many analysts already make changes to incorporate operating leases in their assessments and these proposals are likely to assist them. Others may see the changes as adding complexity. One thing is certain: there will be considerable accounting changes for every entity that has lease arrangements. An adequate transition time will be crucial once this standard is finalized."

To keep our clients abreast and ahead of the curve of change, Avison Young will provide periodic reports on the status of these sweeping changes and provide in-depth analysis of the effect these changes will have on current financial standards, and what the new standards will mean for your business.

OVERVIEW

In August 2010, the International Accounting Standards Board ("IASB") and the U.S. Financial Accounting Standards Board ("FASB") published a joint exposure draft on leases, which will have significant implications on lease accounting in the real estate sector if implemented in its current form.

A significant overhaul in lease accounting standards has been widely anticipated for some time now. In fact, it has been more than 10 years since the core proposals in this exposure draft ("ED" or "Leases ED") were first made. As expected, the proposed standard, if adopted in its current form, will make significant changes to the current approach to

accounting for leases. In summary, it removes the differences between operating and finance leases and brings all lease obligations onto the lessee's statement of financial position as a financial liability.

The proposed guidance would impact almost every organization; however, for real estate occupiers, the proposals are significant. In the past, the majority of property leases were classified as operating leases, and so property rentals were treated as an operating expense in the lessee's financial statements. Under these proposals, lessees would be obliged to bring the net present value of their future lease obligations onto the statement of financial position.

Thankfully for the real estate sector, the expected exclusion for landlords of investment property is contained in the ED. Namely, a property investment company that carries its investments at fair value, following the requirements of IAS 40 Investment Property, would not have to apply this new accounting standard in accounting for its real estate investments. For all other lessors, including property investors that carry their property investments at cost, the impact of the proposals, if implemented in their current form, will be significant.

The comment deadline for the ED is December 15, 2010. The IASB and FASB (the "Boards") plan to undertake further outreach and hold public roundtable meetings, and to issue the new standard by June 2011.

IMPACT ON LEASE ACCOUNTING

The joint project on leases, which is intended to address the complexities associated with lease accounting under both U.S. GAAP and IFRS and off-balance-sheet treatment by lessees, will have the most significant implications for the real estate industry. The Boards originally released their views in a discussion paper entitled Leases: Preliminary Views in March 2009. They formalized those views in an exposure draft issued on August 17, 2010 with comments due from constituents on December 15, 2010 and with a final standard to be issued in 2011. Although, at this point, Avison Young is in the process of interpreting the provisions of the recently released exposure draft, included in the forthcoming sections of this document is an overview of the guidance along with what the changes mean.

The exposure draft proposes a single "right-of-use" lessee model for all leases that would eliminate off-balance-sheet accounting and require most leases to receive similar accounting treatment – classifying a lease as operating versus capital will be a thing of the past. The proposed approach (i.e. the "right-of-use model") would require a lessee to recognize an asset that represents the lessee's right to use the lease property, and a liability, which represents the lessee's obligation to pay rentals for the use of the property. The initial lease obligation would be measured based on estimates of the lease term, contingent rentals, and residual value guarantees, using the lessee's incremental borrowing rate to discount future payments to present value. The right-of-use asset would be amortized over the shorter of its useful life or the lease term and lease payments would be allocated to interest expense and a reduction of the lease obligation using the effective interest method rather than be recognized as rent expense under the straight-line method.

The exposure draft proposes two models for lessors, each to be used in different circumstances depending on the terms of the lease and their effect on the lessor.

The first model, the performance obligation approach, would be used when the lessor retains exposure to significant risks or benefits associated with the leased asset and results in an accounting treatment that is essentially symmetrical to that of the lessee. Pursuant to this model, the lessor would recognize a lease receivable and a corresponding lease liability in an amount that is the same as the lease receivable. The lessor would continue to recognize the leased asset and related depreciation expense. In addition, it would amortize its lease liability and recognize revenue over the lease term with lease payments received being allocated between interest income and a reduction of the lease receivable using the effective interest method.

The second model, the derecognition approach, would be used when the lessor is not exposed to significant risks or benefits associated with the leased asset. Under this approach, the lessor effectively "sells" a portion of the leased asset and recognizes a net profit (or loss) at lease commencement equal to the difference between the present value of the lease payments and the carrying amount of the portion of the leased asset that is not derecognized. Over the lease term, the lessor also recognizes interest income using the effective interest method.

WHAT THIS MEANS FOR YOU

Although the timing of the effective date of the new leases standard is unknown, the changes that would be required based on the exposure draft issued would have broad implications and apply to all companies. According to KPMG's Rothfischer, "the implications extend beyond the preparation of financial statements, as the new leases standard will have significant implications on the way companies do business, structure transactions, communicate expectations to the capital markets and negotiate loan covenants."

While the extent of impact on an individual company would, of course, vary depending on the extent of a company's lease transactions, these implications may include, but are not limited to, the following:

• *Changes and refinements to financial reporting processes* – Certain provisions of the new leases standard would require significant judgments and estimates to be made by management, which will require changes and refinements to be made to companies' quarterly and annual financial reporting processes. Such estimates may include determining the longest possible lease term that is more likely than not to occur based on lease options, whether a purchase option is more likely than not to be exercised, and the expected amount of lease payments to be received, which includes contingent rentals.

• *Changes in lease administration process* – The new leasing standard will require all active leases to be accounted for under the new leasing standard; that is, there will be no grandfathering clause for existing leases. This provision will require extraordinary efforts and will place significant constraints on companies' personnel and information systems.

• *Changes in historical business practices* – In light of the requirement to record the financial reporting effects of all leases on a company's balance sheet, business practices of lessees will likely change. Such changes may involve negotiation of shorter lease terms in order to minimize the effects on an entity's purported financial position. Alternatively, given that operating leases will be "on balance sheet", companies may elect to own their facilities rather than lease them as they may have historically.

• *Changes in financial metrics* – Accounting for leases pursuant to the guidance in the exposure draft will impact corporate financial performance metrics such as return on equity and return on assets. Accordingly, alternative profitability measures, as well as leverage, operating efficiency and liquidity, will likely be developed in order to appropriately portray the financial condition, operational efficiency and profitability of an enterprise in a fashion that most closely resembles the underlying economics of a business.

• *Impact on Capital Markets* – With shorter-term leases likely to be required by lessees, real estate capitalization rates may be driven higher given exposure to lease rollover will become more pronounced, which consequently could have a ripple effect on mortgage finance rates and reversionary capitalization rates. As a result, predicting the future cash flows of properties with short-term lease terms will become more complex as the forecast period extends further into the future.

• *Increased coordination* – The changes to historical lease accounting that would occur as a result of the new leases standard will require increased coordination between all functions of an entity. Given the significance of the judgments and estimates that will need to be made as well as changes in business practices, coordination between all levels of an organization should not be underestimated.

HOW TO PREPARE – WHAT YOU CAN DO NOW

In light of the implications described above and many others, sitting on the sidelines until the final standard is issued is the wrong way to go. Companies should begin the discussion and preparation process today.

The new standard will require lessees to estimate their lease term and periodically assess that estimate, taking renewal, expansion and purchase options into account. It will become imperative for companies to properly administer their real estate portfolios. Those companies with an administration system in place will need to modify the system and those that do not will need to put one in place, not only to track the size, rental obligations and options of their properties, but also to track lease-term estimates.

The financial reporting changes that will result from the adoption of the new leases standard will lead to changes in companies' purported financial position, results of operations, and cash flows. Accordingly companies should begin discussing these effects with all stakeholders who include, but are not limited to, lenders, investors, shareholders and analysts. Keeping them informed will mitigate the risk of inappropriate conclusions being drawn.

In conclusion: change is the order of the day. There will still be significant new accounting pronouncements issued in the near term and the need for active stakeholder participation cannot be underestimated. Avison Young will monitor developments and continue to keep you informed of the timeline, process and changes that may result. ■

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