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PKF Corporate Finance

QUARTERLY INSIGHTS INTO KEY FINANCE MATTERS AFFECTING YOUR BUSINESS

ISSUE 21 | ON CORPORATE FINANCE

OPERATING LEASE CHANGES:

HOW BUSINESSES WILL BE IMPACTED

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NEW LEASING STANDARD – IMPACT ON BUSINESSES AND TRANSACTIONS

By Alastair Richards – Associate Director Melbourne

The way leases are accounted for is changing. The largest change will be to lessees of what are currently referred to as operating leases. The most common operating lease is rental of premises, so if an organisation has such a lease, or any other operating lease, they may be impacted by this change. This article focusses on the impact of this change, as well as the potential ramifications to businesses and their transactions.

What is the change?

Under the existing accounting standard for leases, a distinction is drawn between 'finance' and 'operating' leases. Depending on the terms of the lease, the lease is classified as 'finance' or 'operating'. Under the new leases accounting standard (AASB 16), the distinction between the two is removed with all leases being treated in the same way, which is more in line with the way a finance lease has been accounted for in the past.

Under this new accounting standard, at the beginning of a lease, the leased asset is recognised on the balance sheet of the lessee (a right to use asset). In addition, a liability is also recognised to represent the obligation to pay for the use of the asset. The asset and liability are measured on a net present value basis. Over the duration of the lease, the leased asset is depreciated, and the lease liability is reduced by the lease payments, net of the interest expense on the outstanding lease liability.

Exceptions

Broadly there are two exceptions to applying this new method:

1. Short term leases – if the lease is 12 months or less in duration; or
2. Low value assets – if the value of the asset leased (when new) was of low value.

Determining whether the lease is less than 12 months in duration is relatively straight forward, although options to extend the lease also need to be taken into account. The determination of whether an asset is 'low value' is less clear as the standard doesn't define how much a low value asset is; it does however state that a car would not qualify, as "a new car would typically not be of low value", but "tablet and personal computers, small items of office furniture and telephones" would be low value. It also states that different lessees are expected to arrive at the same conclusion of what low value is, thus it appears the size of the business should not have a bearing on this assessment.

Worked example

In order to further explain the implications, a worked example is included below. For the purposes of this example the following assumptions have been made.

A property is leased with the following terms:

- Rent $10k per month
- Term 24 months
- The contract starts on the first day of the financial year, being 1 July 2019
- Rental payments are made monthly in advance
- The lease documentation does not include the implicit interest rate, but the incremental borrowing rate of the lessee is 5%p.a. (this represents the rate at which the lessee could borrow an amount similar to the value of the leased asset).

Using the above assumptions, we have discounted the lease payments back to the start date of the lease, calculating it to be approximately $228k.

The impact on the balance sheet

The table below shows the impact of the lease before the first payment is made.

Balance sheet as at 1 July 2019, prior to first lease payment			
$ 000s	**Prior to change**	**Post change**	**Impact**
Current assets			
Cash	35	35	-
Receivables and other assets	455	455	-
	490	490	-
Non-current assets			
Leased property (right to use)	-	228	228
	-	228	228
Total assets	**490**	**718**	**228**
Current liabilities			
Payables and other liabilities	(85)	(85)	-
Lease obligation	-	(111)	(111)
	(85)	(196)	(111)
Non-current liabilities			
Lease obligation	-	(117)	117)
Bank debt	(250)	(250)	-
	(250)	(367)	(117)
Total liabilities	**(335)**	**(563)**	**(228)**
Net assets	**155**	**155**	**-**
Gearing (debt to equity)	***161%***	***233%***	
Current ratio	***576%***	***250%***	

As a result of the new leases accounting standard, both assets and liabilities will increase as a result of recognising the right to use leased asset and the lease obligation. The right to use leased asset by nature is classified as non-current and the lease obligation is split into the current and non-current portions. As a result of this change, both the debt to equity ratio and the current ratio are negatively impacted, this is further discussed on the next page.

Over the life of the lease, the right to use leased asset gradually decreases as it is depreciated over the life of the lease. The lease obligation also decreases although it decreases by a smaller proportion at the start of the lease compared to the end of the lease, due to the interest component calculated based on the lease obligation.

Impact on the Income statement

The table below shows the impact of the lease after the first twelve months.

Income statement - 30 June 2020			
$000s	**Prior to change**	**Post change**	**Impact**
Revenue	1,000	1,000	-
Cost of sales	(550)	(550)	-
Gross profit	**450**	**450**	**-**
Rental costs	(120)	-	120
Other administrative costs	(220)	(220)	-
	(340)	(220)	120
EBITDA	**110**	**230**	**120**
Depreciation	(10)	(124)	(114)
Amortisation	(5)	(5)	-
EBIT	**95**	**101**	**6**
Interest	(5)	(14)	(9)
Profit before tax	**90**	**87**	**(3)**
Debt to EBITDA	***227%***	***160%***	

The impact of the new leasing standard is to remove rental costs from the income statement. As mentioned previously, the right to use leased asset is depreciated and an interest expense is incurred on the lease obligation.

The result of this is to increase EBITDA by the amount of the rental costs and also increase EBIT but by a lesser amount; in addition to this net profit before tax is also impacted. The impact to net profit before tax is due to the lease obligation being greater at the start of the lease, thus there being a greater interest expense calculated. As the lease obligation decreases over the term of the lease, so will the interest expense.

Accounting impacts of the new leasing standard

As previously stated, the new leasing standard may have multiple impacts on the financial statements, a selection have been listed below:

- Increased EBITDA
- Increased EBIT
- Increased operating cash flows (due to the reclassification with financing activities)
- Higher interest expense
- Lower profit at the beginning of the lease and higher towards the end
- Assets and liabilities will both increase

As a result of these accounting impacts, there will be commercial as well as transactional impacts, this is discussed on the next page.

> "The determination of whether an asset is 'low value' is less clear as the standard doesn't define how much a low value asset is; it does however state that a car would not qualify, as "a new car would typically not be of low value", but "tablet and personal computers, small items of office furniture and telephones" would be low value."

Commercial and transactional impacts

Below is a selection of potential commercial and transactional impacts which the new standard may give rise to.

Debt covenants – such covenants can vary greatly depending on the terms of the loan, but many are going to be impacted. As liabilities and debt are both higher this may have a negative impact, as will a higher interest expense. However, in contrast, EBITDA and EBIT will increase which would have a positive impact on a range of covenants.

Earnouts – many business purchases include an earnout component which is paid based on profits in the years after sale. Often these earnouts are based on EBITDA, EBIT or profit, three metrics which are impacted by the new leasing standard.

Employee / Director bonuses – bonuses may be based on numerous metrics, one which is often used is EBITDA, thus may be impacted by this accounting change.

Valuation multiples – EBITDA and EBIT, as well as profit are often used in assessing value. As these three metrics may be impacted, it will need to be taken into consideration when performing valuations.

Dividend policy – as interest is greater towards the start of a lease it may result in lower profits at this point, thus distributable profits and dividends may be impacted.

WACC – the weighted average cost of capital may also be impacted due to the increase in interest and debt.

Thin capitalisation – this should also be considered as a lease liability may also impact the debt component of the thin capitalisation calculations and in turn the deductibility of interest.

Lease negotiations – shorter lease terms may be preferred, as shorter leases will result in a smaller asset and liability to be recorded on the balance sheet.

Net leases – greater demand for leases which require the tenant to pay outgoings may be preferred, rather than the outgoings forming part of the lease payments as this may result in a reduced amount that needs to be capitalised.

Sale and lease back – some of the benefits have been eliminated.

Early adoption

Although the new leasing standard won't need to be applied by all Australian entities and for those that do it will only need to be for annual reporting periods beginning on or after 1 January 2019, entities may choose to adopt this accounting standard early or even when they're not required to, in order to benefit from some of the above.

Conclusion

The new leasing standard will have an impact on many entities and transactions, some of which will be significant. This article has been written to provide a high level summary of a selection of these key impacts. Should you require further detail or assistance regarding leases, including how best to address the ramifications of this change to your business or transaction, please contact me or one of my colleagues. ■

THE POOL AVAILABLE FOR CROWDFUNDING JUST GOT BIGGER!

By Andrew Jones, Director Sydney

On 12 September 2018, the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 passed extending the Australian Equity Crowdfunding regime and allowing Australian private companies to raise money from retail investors without having to convert to an unlisted public company.

From early October, Australian private companies with an annual turnover or gross assets of up to $25 million will be able to offer shares to everyday investors via an ASIC-licensed crowdfunding platform, and raise up to $5 million a year.

Investors can put up to $10,000 a year each into an unlimited number of ideas, giving private companies the opportunity to raise funds from potentially hundreds of thousands of investors.

Private companies with crowdfunded shareholders will however be subject to a range of additional obligations:

- Now required to prepare annual financial and directors reports in accordance with Accounting Standards;
- Subject to related party transaction and takeover rules;
- Include details about the offer and shareholders as part of their company register; and
- If raising $3 million or more via crowd sourcing, audited financial statements are now required (increased from $1 million).

These amendments have been long awaited by many and present a great opportunity for companies wanting to raise funds through equity crowdfunding. Contact your trusted adviser at PKF if you want to explore how crowdfunding can benefit your business. ■

THE WAVE IS COMING

By Andrew Beattie – Director Newcastle

"Australia is being transformed by population aging… We are at a critical demographic turning point because the baby boom cohort – the 5.5 million people born between 1946 and 1965 – has begun to turn 65 years of age…By 2030, all baby boomers will be 65 or older" NSPAC 2012

"Retiring Baby Boomers struggling to sell businesses as value of SMEs decline" Sydney Morning Herald, 25 April 2017

"Many Business Owners Can't Sell When they Want To… Owners are woefully unprepared for this event that for probably two-thirds of business owners is likely to occur within the next 10 to 15 years" Forbes, 5 February 2017

"Little attention is being paid to the baby boomer business exit tsunami in Australia" InvoiceX, 22 February, 2016

Directly proportional to the 800% increase in the number of businesses for sale over the past decade, the value of Australian small to medium enterprises (SMEs) has been trending downward for the past 11 years.

Why?

Firstly, because more businesses are coming onto the market – a direct result of baby boomers looking to get out, with no family looking to succeed them in the business as they might have in prior generations. In 2012, 38% of owners planned to pass their business on to the next generation. As of 2016, it's below 25%.

When stacked against competition, does your business stand out? Can you articulate why it **should** stand out? Who is your competition? What are buyers looking for?

Secondly, because many businesses simply leave it too late to consider their exit strategy, more than 70% of private business owners have no business exit or succession plan.

It will take the average business **three to five years** to achieve the things that need to be in place in order to maximise any sale price... **THREE TO FIVE YEARS!**

Becoming sale ready is not a straight-forward or quick process.

A business that seems like a good investment may quickly tarnish under scrutiny, once prospective buyers 'lift the hood'. Generally you only get one bite at the cherry – if your business is assessed and found wanting by a potential purchaser, that opportunity is likely lost.

Thirdly, many businesses are going it alone and have not sought advice about a transition or considered their options:

Trade sale – how do I maximise the value of the business that I've poured everything into?

Family Transition – what does that look like from all sides? Do the kids actually want to take over the business?

Management buy-out – can I be confident the managerial team would be successful if the current owner(s) aren't involved after the transition?

THE WAVE IS COMING *CONTINUED*

By Andrew Beattie – Director Newcastle

Partnership planning – is there a buy-sell agreement in place? What are my partners' exit plans? Will I be left holding the bucket, and then what are my options?

Fourth, many business owners have no idea what they need to retire. They don't know what after-tax income they need to support their lifestyle, or what value their biggest asset – their business – will contribute to their nest egg.

Because of all these factors and even in spite of them, it is wise to think about being 'sale ready' from day one – not necessarily because you intend to sell anytime soon, but because a business that is sale ready is optimised and likely generating the best returns for its owners along the way. It also means that if an opportunity arises, the business is in a position to enable the owners to take it.

Being able to maximise your return means understanding what the market wants. Generally the market wants less risk so you need to create less risk in your business.

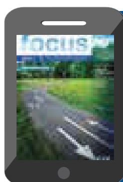
- Have systems and processes in place – don't overthink this. You need documentation so that things can continue to function whether you (or any other particular person) are there or not, and it needs to cover EVERY key process in your business. This reduces 'key person risk', which is one of the biggest inhibitors in maximising a sale.
- Lock in your best and brightest people with incentives and, in many cases, equity.
- Reduce or remove, at the very least mitigate, concentration risks in your customer base.
- Ensure cash flow is sound.
- Lock in income streams on the right terms wherever you can.
- Structure and fund your assets appropriately.
- Implement a disaster recovery plan.
- Put robust governance and reporting structures in place.
- Build a team of the right advisers, with appropriate and proven skills around you so the status quo is challenged. That team of advisers will show you the above list is not comprehensive, but a minimum starting point.

Your plan also needs to start at the end – what value do you need to realise from your business? What can it realise now – and is this in line with your desired value or your expectations? If not, then time is your biggest ally, providing you use it well and have the right people on your team to make sure you get there.

If you want the best chance at your best outcome, don't leave it until you are ready to sell. When you have had enough, you won't have the energy to really get ready.

Returning to the first point – the baby boomers: it's critical that we don't underestimate the impact on the market for Australian businesses. We are moving from a long period of asset accumulation to a significant period of liquidation. A weighty shift in the supply and demand equation.

The wave is coming! ■



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