End of the Operating Agreement

An Accountants Perspective

PRENTICE YATES & CLARK

November 2015

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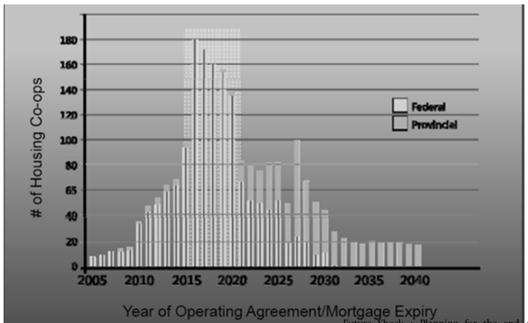
Federal Government Programs

1973-78	1979-85	1986-92
Section 61 (then 34.18)	Section 95 (then 56.1)	ILM (FCHP)

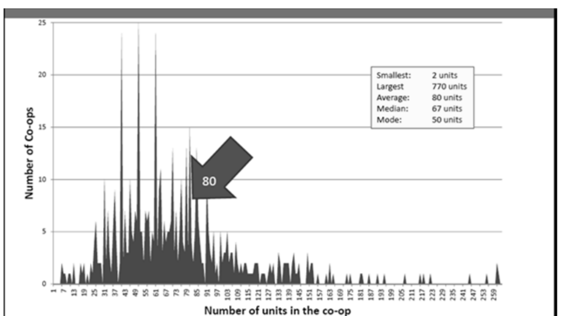
Future Shock : Planning for the end of your operating agreement (CHFC conference 2013)

Time Line



Future Shock : Planning for the end of your operating agreement (CHFC conference 2013)

Co-op Scale in Ontario



Future Shock : Planning for the end of your operating agreement (CHFC conference 2013)

What Will Change?

Physical Infrastructure	
With Operating Agreement	Post-Operating Agreement
An ever-aging building that requires regular maintenance and long term capital upgrades	An ever -aging building that requires regular maintenance and long term capital upgrades

Future Shock : Planning for the end of your operating agreement (CHFC conference 2013)

What Will Change? - continued

Legal & Governance	
With Operating Agreement	Post-Operating Agreement
Provincial Co-operative Act Provincial Co-operative Regulations	Provincial Co-operative Act Provincial Co-operative Regulations
Co-op Rules/Bylaws Occupancy Agreement/ Policies	Co-op Rules/Bylaws Occupancy Agreement/ Policies
Funder Operating Agreement	

What Will Change? - continued

Finances: Income	
With Operating Agreement	Post-Operating Agreement
Housing Charges	Housing Charges
Subsidy money from Government	
Interest on Investments, Laundry, Cable TV, Parking Rental Fees	Interest on Investments , Laundry, Cable TV, Parking Rental Fees

What Will Change? - continued

Finances: Expenses	
With Operating Agreement	Post-Operating Agreement
Debt obligations (mortgage repayment)	New debt?
Maintenance and repairs	Maintenance and repairs
Property taxes Utilities Administration Insurance Professional fees Governance	Property taxes Utilities Administration Insurance Professional fees Governance

End of the Operating Agreement

What are some of the effects?

End of the Operating Agreement - continued

Reserves

- Co-operative can keep the balance of the replacement reserve
- Subsidy surplus reserve balance plus any accumulated interest
  - The Co-operative can keep the balance, announced Nov. 21, 2013 by CMHC

End of the Operating Agreement - continued

Canada Housing and Mortgage Corporation statement:

"Effective immediately, social housing providers whose operating agreements allow for the establishment of a Subsidy Surplus Fund can now retain any money they have in this fund to use after their operating agreements mature. These funds can be used to continue to lower the cost of housing for low-income households living in existing social housing."

End of the Operating Agreement - continued

Subsidy Surplus Reserve Balance

- Restated as Deferred Government Subsidy
  - Moved from net assets to deferred revenue
  - Taken into income as subsidy awarded to members
  - Qualifies as government funded for HST purposes
- Classified as short term and long term
  - Depends on subsidy usage

End of the Operating Agreement - continued

Subsidy

- Monthly subsidy payment may end 1 or 2 months before the end of the agreement (advances)
  - Cash flow considerations

End of the Operating Agreement - continued

Final mortgage payment

- Co-operative needs to clear the title
- Opportunity to seek (re)financing (if needed)
  - Need to have a business plan
  - Fair market value assessment

End of the Operating Agreement - continued

Lease agreement

- Land and fixtures revert back to lessor at the end of the lease term
- Negotiations with lessor (cash flow considerations)

End of the Operating Agreement - continued

HST rebate

- Ineligible for HST rebate (no RGI units or government funding)
- Internal subsidies – do not qualify
- HST rebate may continue as long as units are funded from the Subsidy Surplus Reserve
- Cash flow considerations
- Budget consideration
  - Capital costs
  - Operating costs

End of the Operating Agreement - continued

Repayment of Renovation Retrofit Funding

- Use of Property Clause
  - Maintain its not-for-profit status, continue to own and operate to provide housing benefits to low and moderate income households
- No Sale Clause
  - Shall not sell or dispose of property

Therefore likely no repayment of funds

End of the Operating Agreement - continued

Cash Flow Considerations

- End of mortgage payments
  - Cash savings (no more interest/principal payments)
- Use cash flow to fund:
  - New debt
  - Capital expenditures
  - Internal subsidy if desired

End of the Operating Agreement - continued

Audit requirements

- Refer to the Co-operative's Act for specific details
  - Co-operative's Corporation Act (Section 123.(1)-(1.1))
    - Audit required if:
    - 50 members or
    - $500,000 capital, assets, gross revenues, gross sales
  - Under $500,000 and under 16 members
    - Audit not required if:
    - All members agree in writing
  - Under $500,000 and between 16-50 members
    - Audit not required if:
    - Special resolution is passed

End of the Operating Agreement - Accounting Issues

- No exceptions to GAAP
- All capital purchases recorded as capital assets
- Capital assets amortized over useful life
  - Appliances 8 - 10 years
  - Roof 20 - 25 years
  - Windows 15 - 20 years
  - Computers 3 years

End of the Operating Agreement - Accounting Issues - continued

- Amortization policy required
  - Straight line over the useful life of the asset
- Amortization expense based on capital assets depreciation and not based on principal paid on the mortgage
  - Higher surplus in the first few years

End of the Operating Agreement - Accounting Issues - continued

- Capital reserve
  - No longer externally restricted
  - Reverts to accumulated surplus
- Consider internal capital reserve equal to present value of your long-term reserve plan study/engineering report
- No appropriation to the replacement reserve
  - Resulting in higher surplus

End of the Operating Agreement - Accounting Issues - continued

- No government funding
  - Resulting in lower surplus
- If subsidy is allocated to members
  - Internal subsidy
- Short and long term debt separated

End of the Operating Agreement - Accounting Issues - continued

- Land
  - Previously amortized to $0
  - Requirement to disclose land at cost
  - On a go-forward basis option to disclose land at $1

End of the Operating Agreement - continued

Approvals and Policies

- Board to approve the following:
  - Amortization policy
  - Transfers to reserves from accumulated surplus
    - Annual or formula
  - Internal subsidy policy
    - Guidelines formerly prescribed by CMHC
    - Other impartial method

End of the Operating Agreement - continued

Potential Areas of Concern

- Budget planning
  - Surplus to cover operating expenses and capital work
- Membership awareness
  - New accounting changes
  - Break-even is not enough
  - Plan for future capital renovations paid from surplus
- Not-for-Profit status at risk
  - Due to higher surplus
  - Building condition assessment and long-term planning

End of the Operating Agreement - continued

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Sample Financial Statements

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Statement of Operations

		With Operating Agreement	Post Operating Agreement	Post Operating Agreement, with loan Note 1
Revenues				
Housing charges	$	776,435 $	776,435 $	776,435
Subsidy allocated		(70,807)	0	0
Internal subsidy ???		0	(70,807)	(70,807)
CMHC income tested subsidies		**70,807**	**0**	**0**
Vacancy loss		(9,687)	(9,687)	(9,687)
Investment income		**2,204**	**18,204**	**18,204**
Other revenue		55,912	55,912	55,912
Total Revenues		824,864	770,057	770,057
Expenses				
Mortgage interest		**9,563**	**0**	**43,000**
Amortization loan funded assets		**152,860**	**0**	**60,000**
Amortization capital assets		**0**	**12,000**	**12,000**
Amortization of transaction costs for loan		**0**	**0**	**2,700**
Municipal taxes		54,137	54,137	54,137
Salaries and benefits		104,994	104,994	104,994
Repairs and maintenance, per schedule		45,757	45,757	45,757
Administrative, per schedule		25,187	25,187	25,187
Utilities		131,378	131,378	131,378
Cable		31,191	31,191	31,191
Insurance		9,732	9,732	9,732
Bad debts		1,565	1,565	1,565
Non-recoverable HST		**24,000**	**31,000**	**31,000**
Replacement reserve		**211,200**	**0**	**0**
Total Expenses		801,564	446,941	552,641
Surplus		23,300	323,116	217,416

Note 1 Assumption: Co-operative takes out a $1.5 million dollar loan to help with Capital restoration. Loan bears a 3% interest rate, with annual payments of 124,000 over a 15 year term. Capital assets amortized straight line over 25 years useful life. Transaction costs of $40,000.

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Statement of Financial Position		With Operating Agreement	Post Operating Agreement	Post Operating Agreement, with $1.5 million loan
Current Assets				
Cash and temporary investments	$	318,700 $	227,575 $	172,375
Accounts receivable				
Members (net of allowance $2,500)		13,600	13,600	13,600
Laundry		1,800	1,800	1,800
HST		**6,500**	**0**	**0**
Subsidy		**4,900**	**0**	**0**
Prepaid expenses		5,900	5,900	5,900
Total Current		351,400	248,875	193,675
CMHC Loan Funded Capital Assets		**153,000**	**0**	**0**
Capital Assets		**0**	**116,641**	**1,556,641**
Reserve Funds		**500,000**	**685,000**	**580,000**
		1,004,400	1,050,516	2,330,316

Statement of Financial Position	With Operating Agreement	Post Operating Agreement	Post Operating Agreement, with loan
Current Liabilities			
Accounts payable and accrued liabilities	$ 32,200	$ 32,200	$ 32,200
Prepaid housing charges	7,000	7,000	7,000
Members' deposits	65,000	65,000	65,000
Deferred government subsidy	**0**	**70,807**	**70,807**
Accrued mortgage interest	**700**	**0**	**4,000**
Short term mortgage payable	**0**	**0**	**82,000**
Total Current	104,900	175,007	261,007
Mortgage Payable	**153,000**	**0**	**1,337,000**
Mortgage transactions costs	**0**	**0**	**(40,000)**
Accumulated amortized transaction costs	**0**	**0**	**2,500**
Deferred government subsidy	**0**	**29,193**	**29,193**
	153,000	29,193	1,328,693
Total Liabilities	257,900	204,200	1,589,700
Net Assets			
Restricted			
Capital replacement reserve, per statement	**500,000**	**685,000**	**580,000**
Subsidy/surplus reserve, per statement	**100,000**	**0**	**0**
Unrestricted			
Contributed surplus	3,200	3,200	3,200
Accumulated surplus, per statement	**143,300**	**158,116**	**157,416**
	746,500	846,316	740,616
	1,004,400	1,050,516	2,330,316

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Statement of Replacement Reserve	With Operating Agreement	Post Operating Agreement	Post Operating Agreement, with loan
Balance beginning	$ 400,000	$ 400,000	$ 400,000
Add (deduct)			
Appropriated from operations	**211,200**	**0**	**0**
Interest	**15,000**	**0**	**0**
Expenditures	**(126,200)**	**0**	**0**
Transfer from accumulated surplus	**0**	**285,000**	**180,000**
Balance June 30	500,000	685,000	580,000
Statement of Subsidy Reserve			
Balance beginning	114,807	0	0
Add (deduct)			
CMHC funding	**55,000**	**0**	**0**
Interest	**1,000**	**0**	**0**
Allocation of subsidy to income tested members	**(70,807)**	**0**	**0**
Balance June 30	100,000	0	0
Statement of Accumulated Surplus			
Balance beginning	120,000	120,000	120,000
Add (deduct)			
Surplus	23,300	323,116	217,416
Transfer to replacement reserve	**0**	**(285,000)**	**(180,000)**
Balance June 30	143,300	158,116	157,416

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CHARTERED PROFESSIONAL ACCOUNTANTS

End of the Operating Agreement - continued

Sample Financial Statements Notes

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End of the Operating Agreement – FS Notes - continued

Impact of the Change in the Basis of Accounting

On June 30, 2013 the Co-operative's operating agreement with CMHC expired. The audited financial statements for the year ended June 30, 2013 were prepared using a financial accounting framework prescribed by CMHC.

Starting July 1, 2013 the financial statements have been prepared using Canadian accounting standards for Not-for-Profit Organizations. The transition from the CMHC prescribed accounting framework to Canadian accounting standards for Not-for-Profit Organizations required the following accounting policy changes:

End of the Operating Agreement – FS Notes - continued

(1) Capital expenditures are capitalized and amortized over their estimated useful lives rather than charged directly to reserves or amortized based on principal repayment of term debt used to finance them;

(2) The CMHC prescribed accounting framework required the amortization of land. Under this framework land was fully amortized and currently has a carrying value of $1;

(3) There is no longer a capital reserve fund appropriation from operations;

(4) Investment income earned on the future capital replacement and subsidy/surplus reserve funds is credited to operations rather than directly to the reserves;

(5) Liabilities have been segregated between current and non-current on the statement of financial position.

These accounting changes have been applied on a prospective basis as it was determined to be impracticable to determine the period specific and cumulative effects of the changes.

End of the Operating Agreement – FS Notes - continued

Capital Assets

The capital assets are accounted for at cost and amortized on the basis of their useful life using the following methods and rates:

Exterior Building Improvements post mortgage	Straight-line basis over a period of 20 years.
Interior Building Improvements post mortgage	Straight-line basis over a period of 10 years.
Equipment and appliances	Straight-line basis over a period of 8 years.

End of the Operating Agreement – FS Notes - continued

Capital Assets

			2014	2013
	Cost	Accumulated Amortization	Net Assets	Net Assets
Land	$ 1	$ 0	$ 1	$ 0
Building costs	3,334,822	(3,334,822)	0	0
Exterior building improvements	106,200	(5,560)	100,640	0
Interior building improvements	10,000	(1,000)	9,000	0
Equipment and appliances	8,000	(1,000)	7,000	0
	3,459,023	(3,342,382)	116,641	0

End of the Operating Agreement – FS Notes - continued

Restrictions on Net Assets

The future capital replacement reserve is internally restricted by the Board of Directors. These funds can only be used for major repairs and replacements approved by the Board. During the year the Board approved a $180,000 transfer from the accumulated surplus.

End of the Operating Agreement – FS Notes - continued

Municipal Designation Status for HST Rebates

As of June 30, 2013 the Co-operative's operating agreement with CMHC ended. As a result, the Co-operative is no longer in receipt of government subsidy effective July 1, 2013 and is not eligible for the Municipal designation after the end of the operating agreement.

End of the Operating Agreement – FS Notes - continued

Internal Subsidy

The Co-operative provides housing charge assistance to low income members of the Co-operative throughout the year. Internal subsidy is calculated on a case to case basis subject to periodic income verification. Application for housing charge assistance is approved by the Board using income verification and guidelines formerly prescribed by CMHC.

New Financing

What is the process and requirements for a new mortgage?

New Financing – continued

Process

- **Shop around for a lender**
- **Application for commercial mortgage loan**
  - **Various reports**
  - **Due diligence investigations**

Once approved

- **Formal commitment letter specifying lending terms and conditions**
- **Advances are usually all given out within one year**

New Financing – continued

Loan Amount Determination: (rule of thumb)

- Lesser of 75% of the

1. Appraised value
2. Income approach to value

   (using income and capitalization rate determined by lender)

Interest Rate

- Estimated interest rate 2.6% plus Government of Canada Bond for a similar term

New Financing – continued

Prior to approval

- Audited financial statements and Annual information returns for the past four years
- Property tax bill and confirmation that taxes are current
- Complete rent roll, unit number, unit type
- Building inspection report, reserve forecast and budgets
- Liens, title search
- Lender site inspection
- Other info to be determined by lender

New Financing – continued

Prior to closing

- Budget Review
- Determine a Project Manager (engineer) to provide certificates of capital work completion (advances)
- Ontario Land Surveyor (building and property)
- Mortgage Support Agreement (if using CHFC)
- Other information to be determined by lender

New Financing – continued

Additional Reports

- Appraisal Report
- Environmental Audit
- Building Condition Assessment

All reports are paid for by the Co-operative

New Financing – continued

Appraisal Report

- Provides fair market value of the building and property

Disclaimer:

- At the request of the client, we have been asked to value the property as if privately owned and operated using projected market rents and expenses and not under a co-operative housing agreement

New Financing – continued

Estimated costs

- Brokerage fees 1% of loan
- Lender fees 0.5% of loan
- Third party reports $10,000
- Legal fees estimated $25,000

New Financing – continued

On a $4.5 million dollar loan

Brokerage	$ 45,000
Lender	$ 22,500
Third party reports	$ 10,000
Legal	$ 25,000 plus
Estimated Total Costs	$102,500

New Financing – continued

Lender may request an Interest Reserve

1. Used to fund capital repairs
   - Approval required by lender
2. Used against monthly payments
   - If five years out a spike in interest rate occurs
3. Used if missed monthly payments occur
   - Ensures penalties will be paid

Increases cash payouts on top of monthly interest and principal payments

New Financing – continued

Maintain Covenants

- Debt Service Coverage Ratio of not less than 1.2
- Provide annual audited statements 120 days after year end
- Provide Replacement Reserve Fund Study every 5 years

Breach could cause the Co-operative to be in default

New Financing – continued

Potential Debt Covenants

- **Debt Service Coverage Ratio of not less than 1.2**
  - **Calculated as follows:**

$$\frac{\text{Operating income + interest + amortization - capital expenditures}}{\text{Principal and interest}}$$

New Financing – continued

Covenant Using Sample Financial Statements

$$\frac{\begin{array}{cccc}\text{Income} & \text{+ Interest +} & \text{Amortization} & \text{- Capital}\\ \$217{,}416 & + \$43{,}000 + & (\$60{,}000 + \$12{,}000) & - \$180{,}000\end{array}}{\begin{array}{c}\text{Interest + Principal}\\ \$43{,}000 + \$61{,}000\end{array}}$$

= 1.23

Debt covenant is achieved

New Financing – continued

One time advances

- **Results in paying interest on total loan, when advances are not being used to pay down capital work progress**

Emphasis on Strong Capital Budget Planning

- **Timeline of work completed to agree with advance**
- **Combine capital work where possible**
  - **Preventive maintenance on roof to last additional two years**
  - **Do window replacement one year early**

New Financing – continued

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Potential Areas of Concern

- **What could go wrong?**

Building is put up as collateral

- **Default could result in repossession of the building**
- **Members would become tenants under new third party ownership**

New Financing – continued

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Conclusion

- **Financing is costly**
- **Risk of default**
- **Careful planning of capital work is required**

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Questions & Answers