Point of view

Power and Utilities – implications of the new leasing standard

In a nutshell

- IFRS 16 *Leases* has been published and is effective for periods beginning on or after 1 January 2019, (subject to EU endorsement).
- The distinction between operating and finance leases will no longer apply for lessees, and a right-of-use asset will be recognised on balance sheet together with a lease liability for all but the most insignificant lease arrangements.
- Changes to the definition of a lease mean that arrangements previously outside the scope of lease accounting may now be captured, while others currently in scope may not meet the revised definition.
- EBITDA will generally increase as an operating lease expense is replaced by depreciation and interest, but gearing will also increase, impacting entities' capacity to take on additional debt.
- For lessors, the requirements remain largely unchanged, however as a result of the changes impacting lessees, lessors may see a change in the length and terms of arrangements lessees are willing to enter into.

What's happened?

The International Accounting Standards Board (IASB) has published IFRS 16 *Leases*. For lessees, IFRS 16 introduces a single accounting treatment, recognition of a right-of-use asset and a lease liability. For lessors the current finance and operating lease distinction and accounting remains largely unchanged.

Although IFRS 16 is a result of a joint project with the US standard setter (FASB), and both bring 'operating leases' on balance sheet, there are some key differences with the revised US Standard. In particular, the US Standard still has an operating/finance lease distinction for lessees, such that for 'operating leases' depreciation of the right-of-use asset is a balancing figure, such that the total of the lease interest and depreciation will be a straight line expense over the term of the lease. There is also no recognition exemption in the US Standard for leases of low value items.

Subject to EU endorsement, IFRS 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted if IFRS 15 *Revenue from Contracts with Customers* is also applied. The Financial Reporting Council has proposed updating FRS 102 for consistency with IFRS 16 with effect from 1 of January 2022.

What does it mean for power and utility companies?

The new Standard will bring substantial new assets and liabilities onto a lessee's balance sheet for leases of assets such as properties and cars.

However, the change in definition of a lease will be of particular interest to power and utility companies when assessing long-term arrangements for the purchase of inputs or the sale of output.

IFRS 16 supersedes IAS 17 and IFRIC 4 and includes a revised definition of a lease. Previously, the key question was perhaps not whether an arrangement contained a lease, but rather whether it contained a finance lease. This was because the distinction between operating leases and service contracts did not impact the accounting significantly, as both arrangements were effectively "off balance sheet".

Under IFRS 16, following the removal of the "off-balance sheet" operating lease treatment, the determination as to whether an arrangement contains a lease becomes far more important.
Currently under IFRIC 4 there are three conditions which must be considered in order to determine whether an arrangement includes a lease, being:

- whether the arrangement confers the right to operate one or more assets;
- whether the arrangement grants the right to physical access to the assets; and
- the price mechanism used, including whether the amount charged varies per unit.

In line with IFRS 10 *Consolidated Financial Statements* and IFRS 15, the determination under IFRS 16 of whether the contract contains a lease is based on whether the arrangement confers control. Arrangements which confer a right to operate and the right to physical access will typically result in a conclusion of control under both IFRIC 4 and IFRS 16. This will lead to the recognition of a right-of-use asset and a lease liability for arrangements which meet these criteria, even if, for example, they do not extend over a significant proportion of the asset's life.

However, if meeting the price condition would have been the determining factor under IFRIC 4, it is possible that under IFRS 16 no lease would be identified. As an example, if the price for an output contract was a total fixed price to be paid even if the customer could decide not to take some of the output, this would be viewed as a lease under IFRIC 4, but not necessarily under IFRS 16.

The Standard includes several relevant examples regarding how the above definition should be applied in practice, which are summarised below:

Under IFRS 16, a contract contains a lease if it enables an entity to "control the use of an identified asset, by directing its use and obtaining substantially all the economic benefit from its use for a period of time."

Example	Customer rights	Supplier rights	Other factors	Conclusion under IFRS 16
1 – Solar Farm	Contract to purchase all output over 20 year life of plant. Design of plant specified by customer.	Responsible for building and operating plant and operating and maintaining to customer specifications.	Supplier will receive tax credits for the construction.	Contract contains a lease as the customer has the right to direct how and for what purpose the asset is used, as predetermined by the design of the plant.
2 – Solar Farm	Purchases all output. Schedule of output is pre-determined. Customer has no right of access to the plant or decision making rights.	Owns and operates the plant, cannot substitute the plant. Supplier designed and built the plant with no involvement of the customer.		Contract does not contain a lease since customer rights do not extend beyond those of a customer in a typical supply or service contract.
3 – Solar Farm	Purchases all power over a particular period. Customer issues instructions on operating the plan and controls quantity and timing of delivery.	Supplier operates and maintains the plant.		Contract contains a lease as customer is making the decisions about how and for what purpose the asset is being used.
4 – Fibre optic cable	Right to use three physically distinct fibres within a fibre optic cable. Customer makes decision about use.	Supplier responsible for repairs and maintenance. Can only substitute for reasons of repair, maintenance or malfunction.		Customer has right of control and contract contains a lease.
5 – Fibre optic cable	Right to use specified amount of capacity within fibre optic cable (cable contains 15 fibres with similar capacities).	Supplier determines which fibres are used.		Contract does not contain a lease as the capacity portion is not physically distinct, and hence customer does not control it.

What will this do to KPIs?

EBITDA will generally increase, reflecting the elimination of the straight line operating lease charge, and recognition of depreciation and interest expense. The impact of recognising depreciation on the right-of-use asset and interest on the liability is to front-load expense on an individual lease. The overall impact on net profit will depend on the size and number of lease contracts.

Those with a large number of leases with different maturities may not see a significant overall impact on net profit. However, those with a small number of relatively large leases (such as supply or output arrangements) may see a more significant shift in the timing of profits.

Net debt will increase, changing gearing ratios, potentially impacting covenants and also capacity for entities to take on additional debt. This could have significant consequences in sub-sectors which rely on high levels of gearing to boost equity returns.

On transition, there is a choice between initially measuring the lease liability using an entity's incremental borrowing rate or, by opting to apply fully retrospectively, using the interest rate implicit in the lease. Determining the implicit rate is likely to be more challenging, since an estimate of the residual value of the asset at the end of the lease is required. It is likely that in many cases the implicit rate will be higher than the incremental borrowing rate. If a higher rate is applied, it will reduce the quantum of the liability to be recognised, although interest charges will be higher.

Are there any recognition exemptions?

There are two optional exemptions from the recognition requirements. Entities may elect, by class of underlying asset, to account for leases with a term of 12 months or less as service contracts. Treatment as a service contract is also available, on a lease-by-lease basis, for leases of underlying assets which have a low value when new (e.g. personal computers and small office furniture). An indicative threshold of US$5,000 is included in the basis for conclusions for the purpose of identifying assets of low value.

Are there reliefs at the date of adoption?

As noted above, a key area of judgement will be whether a contract contains a lease.

On adoption, an entity is not required to reassess whether existing contracts contain a lease, but can choose to carry forward the assessments under IFRIC 4 and IAS 17, and apply the definition of a lease only to new contracts entered into after the date of initial application. Having decided whether to apply the lease definition to past contracts or not there are several other options available on transition.

Another decision to be made will be whether to apply the standard fully retrospectively, restating the prior years as if lease accounting had always been applied, or to recognise a liability and right-of-use asset from the date of application. If the latter approach is chosen, the liability is determined using the entity's incremental borrowing rate at the date of application. Choice also exists as to how the right-of-use asset is measured in this case – either as if the standard had been applied since commencement date, but discounted using this incremental borrowing rate or to measure it at the same amount as the liability on initial recognition.
Where can I go for more information? This publication highlights just some of the issues that will be of interest to entities in the power and utilities sector. More detailed information on the new Standard can be found in Deloitte's IFRS in Focus publication, available at www.iasplus.com

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