

## IFRS industry insights

# Implications of the revised leasing exposure draft on the power and utilities sectors

### The Bottom Line

- A revised exposure draft on lease accounting has been published by the IASB with a comment deadline of 13 September 2013.
- More leases will be on-balance sheet for lessees, with the recognition of a right of use asset and a lease liability.
- Amortisation of the right of use asset for non-property leases will be excluded from EBITDA
- The definition of a lease has changed and is focussed on contracts that convey control of specific identifiable assets. Greater judgment may need to be exercised in determining whether arrangements meet these criteria, especially where assets can be substituted and arrangements only cover portions of assets.

### What's happened?

The IASB has published a revised exposure draft (the 'ED') on lease accounting with comments requested by 13 September 2013. Whilst a number of problems identified by respondents to the exposure draft published in 2010 (such as the definition of lease term and the treatment of variable lease payments) have been addressed, in some instances they have been replaced by new issues that will require careful consideration and complexities undoubtedly remain.

### Implications for the power and utilities industry

This publication highlights issues from the latest proposals that will be of particular interest to those in the power and utilities industries. Of course many more complexities exist in the proposals more generally and Deloitte has produced further guidance, exploring the proposals in greater detail which can be found at [www.iasplus.com](http://www.iasplus.com)

### Leases on balance sheets, costs outside EBITDA

The revised ED proposes a dual approach to lease accounting. Lessees would recognise an asset and corresponding liability on their balance sheets for their fixed future lease payments, similar to existing finance lease accounting. For most property leases, a lessee would report a single straight-line lease expense in its income statement, but for most other leases, a lessee would report amortisation of the asset separately from interest on the lease liability.

Aside from a few specific scope exclusions, the only leases that would remain off-balance sheet are those that have a maximum possible term of 12 months, including a presumption that extension options are exercised. The resulting gross-up could be significant.

In contrast to the current treatment for operating lease costs, amortisation of the right-of-use asset under non-property leases will fall outside EBITDA which may impact KPIs and banking covenants. The right of use asset is also subject to impairment under IAS 36 "Impairment of Assets". Any associated impairment charges will also fall outside EBITDA.

**Non-property lease costs will be allocated between finance charges and amortisation of the "right of use" asset.**

**The amortisation charge is likely to be excluded from EBITDA.**

**The definition of what constitutes a lease has subtly changed.**

**More arrangements likely to be considered as leases?**

Under current IFRS, IFRIC 4 “Determining whether an arrangement constitutes a lease” sets out the basic tests for whether an arrangement contained a lease. The ED sets out similar, but not identical, requirements.

	IFRIC 4	Exposure Draft
<b>Criteria used to determine whether an arrangement contains a lease</b>	Dependent upon the use of a specific asset	Dependency on an ‘identifiable asset’
	Conveys the right to use that asset	Right to control the use of that asset

**A capacity portion of an asset that is not physically distinct cannot be a lease under the ED.**

**‘Substantive rights to substitute assets’**

The ED introduces the concept of the supplier’s (ie the potential lessor’s) ‘substantive right to substitute the asset’. Such a right only exists if the consent of the customer is not needed, and there are no barriers (economic or otherwise) preventing the supplier from substituting alternative assets. Further guidance clarifies that substitution in certain circumstances does not constitute this substantive right, if, for example, related to poor asset performance, upgrades, or the ability to substitute assets only in the future.

This concept of the ‘substantive right’ is expected to limit the scope of lease accounting to those arrangements where the supplier has limited ability to substitute assets in fulfilling its obligations. An example of where this may be relevant is where a power off-take contract does not specify whether a generator must deploy its own assets or may instead purchase energy from the grid to fulfil its obligations.

**Lease arrangements confer the right to control the use of an asset.**

**Separately identifiable components of assets under arrangements**

The ED is clear that a distinct portion of an asset can be treated as identifiable, but a share of an asset that is not physically distinct cannot be so treated unless it represents ‘substantially all’ the capacity. This could prove to be very important in the energy sector, for example regarding capacity arrangements relating to a pipeline or power plant, which may fall outside the scope of the ED.

**The right to “economic benefits” excludes tax benefits based on asset ownership.**

**‘Controlling the use’ versus ‘right to use’**

The ED definitions are based on ‘controlling the use’ of an asset, which may be different to the IFRIC4 definition of a ‘right to use’. The control of the use of the asset is based on the ability to make the decisions about the use of the asset that most affect the economic benefit of the asset, such as how it is used, operated, who operates, etc. The change in emphasis envisaged may require a greater degree of judgment to be exercised when determining whether an arrangement is a lease.

The ED includes two examples based around power station off-take contract where the customer purchases the output of a power plant. A line is drawn between a situation in which the customer has the right to either operate and maintain the plant itself (or appoint another party to do so) and where the customer’s only decision making responsibility relates to dispatch instructions. In practice, such off-take agreements may specify methods of operation (such as maintenance cycles, numbers of start/stop cycles, etc.) that blur the distinction drawn in the ED, and judgment may accordingly need to be exercised in specific circumstances.

### “Right to substantially all economic benefits”

The final test in the ED is that the customer has the right to obtain substantially all the potential economic benefits for the use of the asset throughout the contract term. “Economic benefits” is widely drawn, but would exclude tax benefits associated with asset ownership (although would include renewable energy credits derived from asset use). Thus in a regime where renewable energy credits are not provided by way of tax credit, and are retained by a renewable generator, then this may make an off-take arrangement less likely to meet the criteria for treatment as a lease.

### Key discussion points

We can foresee debates in the power and utilities sectors around a number of arrangements including –

- Whether a pipeline contract for say 75% of the pipeline capacity gives the customer the rights to ‘substantially all’ the economic benefit of the pipeline. The conclusion reached may differ from that under IAS 17, which would typically consider whether a contract conveys simply the “majority of risks and rewards”.
- Whether a power off-take arrangement provides sufficient control to the customer such that the customer has the ability to direct the use of the power plant;
- Whether renewable energy credits are based on usage and retained by a renewable generator then this economic benefit is not transferred to the user of the asset;
- Whether a contract to take power from 2 of the 4 units of a power plant represents a physically distinct portion of the plant, or not physically distinct (the units may be physically distinct, but other vital kit may be common).

### Areas impacted by the proposals

Banking covenants	Recognition of an asset and liability could affect key balance sheet ratios. Changes in expense profiles, could impact covenants based on interest cover.
Key performance indicators	Metrics such as return on capital and adjusted earnings measures (EBIT, EBITDA) may increase as costs previously included in these captions may now be reclassified elsewhere.
Reporting systems	Systems would need to capture all information and the ED proposes further new disclosures.
Remuneration	Performance related pay schemes could be impacted due to changes in KPIs.
Earnouts	Contingent consideration arrangements may need to be considered if earnings measures are significantly impacted by the change.
Tax	Contingent consideration arrangements may need to be considered if earnings measures are significantly impacted by the change. The recognition of leases on balance sheet and the profile of the associated expense may have a knock-on effect on tax, although this will vary by jurisdiction. Both the cash tax charge and deferred tax may be impacted for lessors and lessees.

### Resources

More detailed information on the revised ED can be found in Deloitte’s IFRS in Focus publication available from [www.iasplus.com](http://www.iasplus.com). You can also register on IASPlus to receive newsletters that provide updates whenever the leasing project is discussed at IASB meetings. The revised exposure draft itself can be accessed on the on the IASB website at [www.iasb.org](http://www.iasb.org).

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