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What are the potential impacts of leasing polluting assets?

28 June 2021

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Companies that lease polluting assets could face a variety of issues with significant financial statement impacts – e.g. impairments, reassessments and modifications.

What's the issue?

Many companies that are particularly affected by climate-related matters lease polluting assets for use in their business. This includes leases of transport assets and embedded leases – e.g. power purchase agreements that contain leases of coal-fired power plants. Many of these agreements are long-term in nature.

Changes in the future use of these assets could affect lease accounting now. The accounting impacts will often depend on whether the lease agreements contain renewal or termination options.

- For lease contracts with no renewal or termination options, key issues will include the possibility that the right-of-use asset may be impaired or subject to accelerated depreciation. Renegotiating these lease contracts could cause complex lease modification accounting issues.
- For lease contracts with renewal or termination options, changes in economic incentives to use or cease using an asset in the future will often trigger reassessments of the lease term, leading to remeasurements of lease assets and liabilities.

Changes in the expected use of leased assets can also affect the accounting for related items – e.g. maintenance and restoration obligations within lease contracts.

Getting into more detail

Impairment considerations

The principles and procedures of IAS 36 *Impairment of Assets* that apply to impairment of other non-financial assets apply equally to right-of-use assets. For example, right-of-use assets are allocated to cash-generating units (CGUs) and an impairment test is performed when, and only when, it is required by IAS 36[1].

However, additional considerations apply, such as whether to include the lease liability in the carrying amount of the CGU and how to treat obligations arising in lease contracts that are not reflected in the lease liability – e.g. variable lease payments and indirect taxes. *[Insights 3.10.670]*

Accelerated depreciation

Companies may be required to reassess the useful life of right-of-use assets. For example, if the remaining lease term is 10 years but a company decides that it will use the underlying asset only for five years, then it will need to depreciate

1 Right-of-use assets that meet the definition of investment property and are measured at fair value are excluded from the scope of IAS 36.

the right-of-use asset over its five-year useful life. This will lead to accelerated depreciation. *[Insights 5.1.350]*

Lease modifications

Companies may seek to renegotiate leases of polluting assets – e.g. to introduce termination options or end the lease early. Changes that result from renegotiating the lease contract are lease modifications. *[Insights 5.1.135]*

A lessee accounts for a lease modification that is not a separate lease by remeasuring the lease liability. To do so, the lessee discounts the revised lease payments using a revised discount rate and:

- for lease modifications that decrease the scope of the lease, decreases the carrying amount of the right-of-use asset, and recognises a gain or loss that reflects the proportionate decrease in scope; and
- for all other lease modifications, makes a corresponding adjustment to the right-of-use asset. *[Insights 5.1.372]*

Reassessment of options

Changes in economic incentives to use or cease using an asset in the future will often trigger reassessments of renewal and termination options. This can change the lease term and lead to a remeasurement of lease assets and liabilities using a revised discount rate. *[Insights 5.1.310, 330]*

Other lease-related obligations

If a company ceases to use a leased asset, then ongoing maintenance obligations in the lease contract may become onerous. This could require it to recognise a provision under IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*. Similarly, the timing or amount of the expenditure required to fulfil restoration obligations in lease contracts could result in the remeasurement of existing provisions. *[Insights 3.12.150, 600]*

See our **Lease term** and **Lease modifications** publications for more guidance.

Disclosures

Companies need to provide clear and meaningful disclosures about the nature of their leasing activities and the significant judgements they have made. *[IFRS 16.59, IAS 1.122]*

IAS 36 requires disclosure of the key assumptions used to determine the recoverable amount of the CGU. It also requires sensitivity disclosures if a reasonably possible change in a key assumption would cause the CGU's carrying amount to exceed its recoverable amount. *[IAS 36.134(d)–(f)]*

Actions for management to take now

- Identify leases of polluting assets and document the key lease terms – e.g. existence of termination options and restoration obligations.
- Assess whether there are any indicators of impairment for the CGUs to which the right-of-use asset relates.
- Assess whether depreciation periods for right-of-use assets are appropriate and what factors might cause those periods to change.
- Consider enhancing sensitivity disclosures and disclosures about the key assumptions made and major sources of estimation uncertainty.
- Consider the impact of changes in economic incentives on whether a company is reasonably certain to exercise, or not to exercise, renewal or termination options.

– Provide clear and meaningful disclosures about significant judgements and estimates made.

References to 'Insights' mean our publication **Insights into IFRS**

Publication name: *What are the potential impacts of leasing polluting assets?*

Publication date: June 2021