Lessors – How will climate-related risks impact operating and finance leases?

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What's the issue?

Our **article** on leases of polluting assets highlights issues arising for lessees of assets such as transport assets (e.g. aircraft). The same underlying climate-related risks will also impact lessors, though the specific accounting issues will differ.

For a lessor, the key accounting issues will often be valuation and impairment of underlying assets and lease receivables. Lessors will also need to consider income recognition and how to deal with requests from lessees to modify leases or terminate them early.

Climate change impacts could be profound in certain industries that will need to invest in greener technologies and products – e.g. the energy, aviation and automobile industries. Other sectors such as real estate could also be affected by climate-related regulations. For example, transitioning to a hybrid working model could reduce the need for large office spaces.

Getting into more detail

Valuation and impairment: Operating leases

Under an operating lease, a lessor's underlying asset (e.g. aircraft or power plant) may be exposed to valuation and impairment issues such as the following.

- If demand from lessees for that underlying asset decreases, then the lessor may need to consider whether the asset is **impaired**.
- Useful lives and residual values of underlying assets could decrease because of technical or commercial obsolescence. For example, environmentally preferable technologies may be developed or climate-related regulations might change – e.g. legal restrictions on use of assets.
- If the underlying asset is investment property, then climate-related risks could affect the asset's fair value.

"Companies that lease assets to customers could face a variety of issues with significant financial statement impacts – e.g. impairments of underlying assets and lease receivables, and requests to modify leases or terminate them early."

Valuation and impairment: Finance leases

Under a finance lease, the lessor's net investment in the lease generally contains two elements: the receivable due from the lessee and an unguaranteed residual value. A lessor might need to consider the following when determining whether the net investment in the lease is exposed to valuation and/or impairment issues. *[Insights 5.1.510.10]*

- ***Cash inflows:*** Climate-related matters could affect the cash inflows arising from the net investment if the leased asset is subject to restrictions on its use. A change in the expected cash inflows would also require the net investment to be assessed for impairment under the requirements of IFRS 9 Financial Instruments. *[Insights 5.1.520.10]*

- ***Discount rate:*** When determining the discount rate, lessors may need to consider whether climate-related risks are factored in appropriately. This could affect the finance income that the lessor expects to earn during the lease term.
- ***Recoverability of unguaranteed residual value:*** Lessors need to reassess regularly whether the unguaranteed residual value is recoverable. The fair value of an asset at the end of its lease term that can be used only if it is climate-compliant could be significantly less than initial estimates. *[IFRS 16.77]*

Other considerations

Other climate-related matters that could affect a lease's terms and conditions include the following.

- Climate-related matters could mean more uncertainty about using assets that are not environmentally friendly. This could result in a lower probability of leases being extended or purchase options being exercised, leading to shorter-term leases.
- Lessors may need to reconsider the classification of finance leases if lessees do not exercise renewal or purchase options that the lessor had previously expected them to exercise. *[IFRS 16.21]*
- The introduction of new climate-related policies (e.g. a carbon tax) could lead to higher maintenance and insurance costs or change the manner in which the asset is used. This could be a trigger for impairment.
- If new climate-related policies require significant adaptation of underlying assets, then questions on whether the lessor or the lessee is obliged to meet the cost could trigger impairments or lease modifications.

Disclosures

- For an operating lease, if changes are made to the useful life or residual value of the underlying assets, then the company discloses the nature and amount of the change in estimate in current or future periods. *[IAS 8.39]*
- For a finance lease, if there are any changes to the net investment in the lease, then the company provides appropriate quantitative and qualitative disclosures. *[IFRS 16.93]*
- Disclosures on maturity analysis for lease receivables (operating and finance leases) may need updating for any changes in the amount and/or timing of cash flows. *[IFRS 16.94]*
- In cases of significant exposure to climate-related risks, estimates of useful lives and residual values are likely to be subject to higher estimation uncertainty. If there is a significant risk of a material adjustment to the carrying amounts of leased assets within the next financial year, then a company also discloses information about:
  - the assumptions that it has used to estimate the useful lives or residual values of those assets (and other major sources of estimation uncertainty at the reporting date); and
  - the nature and carrying amount of those assets. *[IAS 1.125]*

For more guidance on disclosure of climate-related matters see **Have you disclosed the impacts of climate-related matters clearly?**

Actions for management to take now

- Identify lease arrangements that are expected to be impacted by climate-related matters – e.g. leases of polluting assets.
- Evaluate the impact on the accounting, systems and processes for lease contracts that are expected to be affected by climate-related matters.
- Assess whether the impact of climate-related matters is reflected in the useful lives and residual values of the leased assets.

- Determine the recoverability of lease receivables that are expected to be impacted by climate-related matters and make appropriate impairment write-offs.
- Provide clear and robust disclosures, especially of the key judgements and estimates affected by climate-related matters.
- Ensure consistency of assumptions used in relevant areas of the company's financial statements and that they are in sync to the extent appropriate with information related to climate-related risks discussed elsewhere in the annual report. Consider providing additional explanations in the annual report where inconsistencies arise.

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

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