New Lease Accounting

Have you noticed something new on our balance sheet? A new item named **right-of-use assets** joined our financial statements for the first time. This is a product of the new lease accounting standard, HKFRS 16, which introduces a new lease definition, resulting in significant changes in the way lessees recognise both the leased assets and the associated liabilities on the financial statements. For lessors, accounting largely remains the same. Let's dive into the details to understand the main impact of this new standard.

"Effective on 1 January 2019, the old lease accounting standard HKAS 17 has been replaced by the new standard HKFRS 16 which brings a new era to lease accounting, including a new lease definition and changes to the lessee accounting model."

Lessor or lessee?

Before going into the detail of the new lease accounting standard, let's refresh the meaning of lessor and lessee. A lessor is the party who owns the asset and rents it out. A lessee is the party who rents the asset from the lessor. It is important to understand the identity of each party as the new lease accounting standard brings an unequal impact to lessors and lessees. While it makes radical changes to the current lessee accounting model, it retains the operating and finance lease models for lessors.

The new standard also includes an updated definition of lease. Under the new definition, contracts previously identified as leases may be scoped out and vice versa for both lessors and lessees.

Impact on lessors and lessees

	Lessors	Lessees
New lease definition	▪ Contracts may change their existing lease classifications under the new definition	
Lease accounting model	▪ No impact ▪ Retain the current operating and finance lessor accounting models	▪ Fundamental changes ▪ Adopt a single lessee accounting model ▪ All lessees are required to reflect a right-of-use asset and a lease liability on their balance sheets

When is CLP a lessor or a lessee?

Usually, people may think of a lessee as a tenant or renter, while the lessor is the landlord or owner. Obviously, CLP is a lessee when renting land and buildings for its daily operations, however, could CLP be a lessor in its electricity generation business?

With the capital-intensive nature of the power industry, CLP usually enters into Power Purchase Agreements (PPA) to ensure offtakers purchase substantially all the output produced by power plants. According to the new lease definition, for these PPAs, CLP may act as a lessor that owns the power plants and "rent" them out to the offtakers. Jhajjar's PPA is one example of CLP acting as an operating lessor.

New lease definition

In the past, the process to identify a lease contract (HK(IFRIC) - Interpretation 4) was hard to understand and complicated to apply, resulting in contracts being qualified as leases without properly reflecting their commercial substance. The new standard presents a clearer lease definition, which plays a key role in identifying lease contracts.

A lease is now defined as a contract which provides a customer with the right to control the use of an asset. This definition is further substantiated if:

- there is an identified asset; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for a consideration.

When assessing whether the customer has the right to direct the use of the identified asset, the party (the customer or the supplier) who has the right to direct how and for what purpose the identified asset will be used throughout the period of use, is the key to reach a conclusion.

Identification of a lease contract

Is there an identified asset? — No → Contract is not (does not contain) a lease

↓ Yes

Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use? — No → Contract is not (does not contain) a lease

↓ Yes

Does the customer have the right to direct the use of the identified asset throughout the period of use? — No → Contract is not (does not contain) a lease

↓ Yes

Contract is (contains) a lease

New lease definition – impact on CLP

It is usual for CLP to enter into offtake contracts whereby the customer purchases substantially all the output produced by a power plant ('economic' element). Under the old guidance, if the price per unit of output was neither fixed nor equal to the market price ('price' element), the contract would be classified as a lease.

The lease definition has now changed to focus on who can control the use of the underlying asset during the period of use. The customer must also have the right to direct the use of the asset ('power' element), that is the right to change what type, when, where and how much of the output is produced.

Following the change in definition, when assessing whether an offtake contract is a lease we now put greater focus on the power element, to assess who (CLP or the customer) has the right to decide the amount (how much) of power supply, and the timing (when) of generation and dispatch of that supply.

Elements to consider in lease identification		Old definition	New definition
Economic element	Does the customer obtain substantially all the benefits from the use of the asset	Consider	Consider
Price element	Whether the price per unit of output is neither fixed nor equal to the current market price	Consider	Removed
Power element	Who has the right to direct how and for what purpose the identified asset is used	Not consider	Consider

This year, CLP adopted the new definition for the first time. We have assessed the existing offtake contracts based on the economic and power elements mentioned above with no change of lease classification noted. Details about the first-time adoption of the HKFRS 16 are set out in Note 3 to the Significant Accounting Policies of the Financial Statements.

New lessee accounting model

Other than presenting a new lease definition, another change is the introduction of a single accounting model for the lessees.

Why the need for a change?

In the past, lessees distinguished between finance leases (on balance sheet) and operating leases (off balance sheet) based on the extent that risks and rewards were transferred to the lessee. A finance lease was like buying an asset financed by debt. Over the lease term, the lessee would recognise depreciation on the asset and interest expenses on the liability. In contrast, operating leases were effectively rental agreements, where no asset or liability were recognised on the balance sheet of the lessee, and periodic lease payments were booked as rental expenses.

Before the introduction of HKFRS 16, credit rating agencies used to adjust financial statements in order to “recognise” operating leases on the balance sheet of the lessee, simulating the purchase of the asset via debt issuance. The balance sheet was adjusted to increase debt and fixed assets in line with the value of the lease commitment. With the intention to increase transparency and comparability, and provide a more accurate view of a company’s contractual liabilities, this new single lessee accounting model is now introduced to supersede the old operating and finance lessee models.

What are the changes?

In essence, a lease is an acquisition of a right to use an underlying asset (right-of-use asset) with the purchase price to be paid in instalments (lease liability). Therefore, under the new accounting model, a lessee is required to record these right-of-use asset and lease liability on its balance sheet. How are these new balance sheet items measured?

> *“Previously unrecorded leased assets and liabilities are now recognised.”*

Right-of-use asset

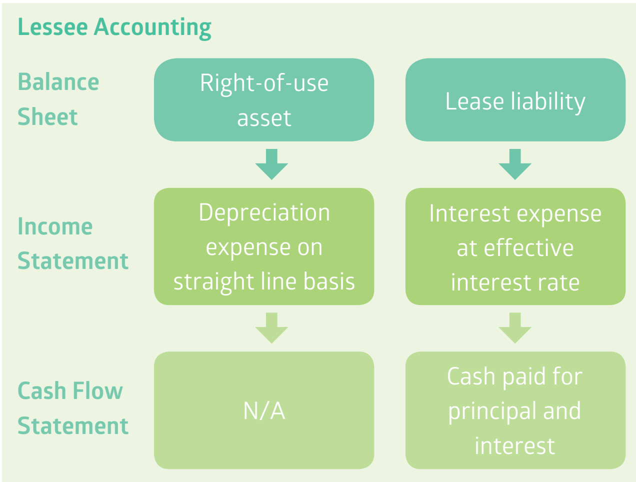
The right-of-use asset is valued by reference to the consideration to be paid by the lessee. At initial recognition, the value of the right to use an underlying asset equals the lease liability, adjusted for any prepayments, lease incentives or other direct costs for the lease. If there are no such prepayments, incentives or other costs, the right-of-use asset and lease liability are equal.

Lease liability

At the commencement day, the value of the lease liability is the present value of the future lease payments. The discount rate is either an implicit rate given in the lease, or the lessee’s incremental borrowing rate, if no rate is included in the lease. Payments that vary according to future indices or rates are calculated at the current index or rate. Payments depending on other factors, such as those linked with lessee’s performance, are not included in the lease liability.

What are the impacts?

The overall effects to balance sheet, profit and loss and cash flows brought by the new lessee accounting are illustrated in the diagram below.



The capitalisation of right-of-use assets and lease liabilities may have a significant impact on the financial ratios of a lessee. Total assets and total liabilities, net income, and key financial ratios, such as debt to equity, debt to assets, return on asset, and return on equity will be affected.

Lessee accounting model – impact on CLP

Lease contracts where CLP is the lessee are mainly on land and buildings. In the past, outstanding lease payments were not recognised on the balance sheet but disclosed as operating lease commitment. On the adoption of the new single lessee accounting model, CLP recognised its previous operating leases on the balance sheet as right-of-use assets together with an equal amount of lease liabilities. However, due to the nature of CLP’s business, the amount involved is relatively insignificant. Accordingly, impacts on the financial ratios of CLP are also immaterial. Detailed information can be found in Note 3 to the Financial Statements.